



# **NAVAL POSTGRADUATE SCHOOL**

**MONTEREY, CALIFORNIA**

## **THESIS**

**GERMANY, THE EUROPEAN UNION, AND THE EURO:  
THE PRIMACY OF POLITICS IN TREASURE**

by

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POLITICS IN TREASURE**

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## **ABSTRACT**

The Federal Republic of Germany has arisen to take a leadership position in the Eurozone sovereign debt crisis. This quasi depression has highlighted the economic interdependence of the Eurozone member states and has exposed the fundamental weakness of the lack of a political union between members to coordinate a timely fiscal response. This thesis examines why the Federal Republic of Germany became the cornerstone for Eurozone monetary stability; how the country contributed and what it has sacrificed thus far towards the crisis; and surveys what Germany must do in the future to ensure European financial stability.

Germany's current commitment to the continent is examined here through the treaties that economically linked the European nations and formed the foundation for the Eurozone. In addition, the weaknesses of periphery member states that contributed to the crisis and the substantial sovereign economic bailouts and recovery packages that have been enacted by the Troika are analyzed.

The thesis then examines the three options that are available to the Eurozone: to continue to "muddle through" the crisis, to enact substantial reforms, or to splinter and break-up the Union. The results support the choice for greater political integration and the need for the issuance of Eurobonds.

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## **LIST OF ACRONYMS AND ABBREVIATIONS**

ARRA	American Recovery and Reinvestment Act
ASEAN	Association of Southeast Asian Nations
CFSP	Common Foreign and Security Policy
EC	European Community
ECB	European Central Bank
ECSC	European Coal and Steel Community
EDC	European Defence Community
EDP	Excessive Deficit Procedure
EEC	European Economic Community
EERP	European Economic Recovery Plan
EFSF	European Financial Stability Facility
EMI	European Monetary Institute
EMU	Economic and Monetary Union
ERP	European Redemption Pact
ESM	European Stability Mechanism
EU	European Union
Euratom	European Atomic Energy Community
FDI	Foreign Direct Investment
FRG	Federal Republic of Germany
GDP	Gross Domestic Product
GDR	German Democratic Republic
GIIPS	Greece, Ireland, Italy, Portugal, Spain
GNP	Gross National Product
IMF	International Monetary Fund
LTROs	Long-term Refinancing Operations
NAFTA	North American Free Trade Agreement
NATO	North Atlantic Treaty Organization
OECD	Organisation for Economic Co-Operation and Development
OMT	Outright Monetary Transactions
SEA	Single European Act

SGP	Stability and Growth Pact
SMP	Securities Market Programme
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union

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# **I. INTRODUCTION**

## **A. MAJOR RESEARCH QUESTION**

On 1 January 1999, a new era began for the European Union with the introduction of the euro currency and the implementation of the Eurozone.<sup>1</sup> At the same time, and without the benefit of hindsight to reveal the future implications, this event posed a significant parting of the ways for the entrenched political values and economic principles of Germany. The decision to create this new economic union took place at a time when Germany was in the rigors of reunification, and created an environment where observers could poorly foresee the impact that future economic challenges would have in the euphoria attendant to the end of the Cold War. On the opening day of 1999, participating members ceased their sovereign rights to their national currencies and began an age of monetary interdependence as part of the ongoing reconstruction of Europe that had begun in the 1950s, if not before. Eight short years later the honeymoon period of economic unity came to a screeching halt with the spread of the global economic recession of 2007–2008. The exponentially increasing burden on member states soon created a financial crisis for those Eurozone members on the periphery of the union, most notably Greece, Italy, Ireland, Portugal, Spain (GIIPS), and later Cyprus, who attempted to manage the accumulation of massive and unsustainable deficits. This rise of unprecedented public debt levels ultimately triggered a Eurozone sovereign debt crisis.

This crisis highlighted the economic interdependence of the Eurozone members and quickly divided the union into those countries who were financially stable and those who were not. In addition, the crisis exposed a weakness of the economic union, as it demonstrated an underlying lack of a political union between members to coordinate a timely fiscal response. As a result, the lack of political will in individual member states to take the necessary measures at the initial signs of fiscal problems allowed the situation to grow into a crisis that threatens the continued existence of the Eurozone and the

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<sup>1</sup> On 1 January 1999, the euro currency was implemented for non-cash transactions; on 1 January 2002, euro notes and coins became legal tender.

common currency. This lack of a unified response demonstrated that this debt crisis was as much about politics as it was about economics.

The country that eventually arose to take a leadership position in the Eurozone sovereign debt crisis has been the united Federal Republic of Germany (FRG). This unanticipated role has developed as the country continues to integrate itself with some skill and adeptness into a globalized economy via its imperative of the social market economy and exports of high quality manufactured goods. German Chancellor Angela Merkel has clearly stated that Germany is “‘deeply committed’ to the euro zone and ‘determined to do everything to protect it.’”<sup>2</sup> The leadership’s unwavering commitment to defend the European economic union may be examined and analyzed as this study proposes to do. In doing so, a research question may be proposed: Why has the government of Germany volunteered to become the cornerstone for Eurozone monetary stability, how has the country contributed and what has it sacrificed thus far towards the crisis, and what must Germany do in the future to ensure European financial stability? In addition, what in the past explains this development and what stresses and strains in the fabric of Europe, and its nations among themselves, explains this startling and significant phenomenon?

## **B. IMPORTANCE**

The financial meltdown of 2007–2008, which originated in the United States, quickly became a threat to the global economy. As after 1929, nowhere was this collapse felt more than in the Eurozone countries. Those European states that had only recently come to prosperity in the boom of the 1990s, and which had intensified their liberal fiscal policies during the growth period of the early days of the euro, soon realized they had created unsustainable public debts when income and credit faded. Unlike nations with independent monetary policies, Eurozone members were limited in what they could do to counter the negative fiscal trends in their constrained union. Harder hit members, which in the past may have chosen the option to devalue their currency, no longer had the

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<sup>2</sup> Brian Blackstone and Charles Forelle, “Germany, France Back Pledge to Save Euro,” *The Wall Street Journal*, July 27, 2012, <http://online.wsj.com/article/SB10000872396390443931404577552920809640442.html>.



ability to perform this measure. Instead nations had to enact strict and unpopular austerity measures to counter their rising sovereign debt. This solution, in turn, quickly led to a decrease in demand in the domestic markets and created barriers for economic growth. As a result, economic hardships persisted that soon gave rise to nationwide riots and the subsequent toppling of several state governments.

The sovereign debt crisis spawned the possibility for the collapse of the Eurozone. The consequence of this possible economic failure, which still exists today, would send shockwaves throughout the largest trading and monetary union of modern times and would severely hinder the continued recovery of the recent worldwide recession. The main facilitator in thwarting this seemingly inevitable collapse was the German intervention in the crisis. This country, which only 68 years ago was physically, emotionally, and economically devastated after two World Wars, rose to become the pivotal member state of the Eurozone.

The Federal Republic of Germany's transformation in the post-World War II period has allowed the country to become a leader in the Eurozone. The nation was able to effectively rebuild its economy in the postwar period, endure its position on the front lines of the Cold War, and successfully incorporate the German Democratic Republic (GDR) state once the Soviet Union collapsed. Any of these hurdles could have prevented the reemergence of a strong and viable domestic economy and instead could have created an unstable and factious land in Central Europe. In addition, the German nation survived the fiscal collapse and inflationary explosion of the years between the two World Wars, and as a result, ever since rebuilding began in the country this harsh lesson has ingrained itself in monetary policy. The values and economic discipline that Germany enacted has allowed the nation to endure the Eurozone crisis and positioned the country to rightfully demand strict austerity measures on weaker member states.

The enduring fiscal instability of the peripheral Eurozone member nations continues to pressure the European Union and threatens the future of the Eurozone. The crisis has strained relations among European leaders and institutions, and created an opening for the rise of political extremism and for the creation of factions within member governments. As Germany has previously taken the leadership role in the crisis, the

country has the opportunity to use its strong fiscal position to ensure European financial stability. Germany has the monetary means, economic clout, and proven track record to deliver a rapid and overwhelming resolution to the Eurozone crisis.

### **C. PROBLEMS AND HYPOTHESES**

The research question examines the political aspects of this economic crisis. In doing so, a solid background of the principles of economic theory and policy must be presented. The economic discussion of the Eurozone crisis must include an examination of what caused the financial crisis and the instruments available to resolve the situation. This will include a study of the forces that led to the crisis, including the propensity to overlend and overborrow, the global economic recession, the limitation of exchange rate manipulation, the pressures of short-term debt, and the possibility of European contagion. In examining the ways to resolve the Eurozone crisis, the two types of relief that may be utilized include rescue packages and debt restructuring. In enacting these two types of resolutions, the possibility of moral hazard and a free-rider problem must be considered. Finally, recent changes and proposed future solutions for the crisis may be discussed, which include increased bank regulation and supervision, and the use of capital controls.<sup>3</sup>

An additional investigation of the political decisions and those who make the economic choices must be evaluated. This will be highlighted with the evolution of the German leadership's decision to defend and save the Eurozone at any cost. In examining the country's role in the financial crisis, other key players may be observed in relation to the decision-making process, including the leadership of the European Central Bank and the leadership of the Deutsche Bundesbank.

Germany's commitment to the continent may be examined through the treaties that economically linked the European nations and formed the foundation for the current Eurozone. These include the European Coal and Steel Community Treaty of 1951, the European Economic Community established in 1957, and the Single European Act of 1986. In addition, the 1992 Maastricht treaty, and the Lisbon treaty signed in 2007,

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<sup>3</sup> Thomas A. Pugel, *International Economics* (New York: McGraw-Hill/Irwin, 2009), 526–39.

formed the origin of the modern EU and the euro currency. Studying the progression of European financial integration will assist in understanding Germany's obligation to the Eurozone.

Another area of analysis will include the role of the European Central Bank (ECB) in the sovereign debt crisis and the institution's relationship with Germany. In unison with Germany, the ECB's leadership has also stated that the bank will do "whatever it takes to preserve the euro as a stable currency."<sup>4</sup> The strong connection displayed between one of the 17 member states and the supranational organization will be examined. Furthermore, the recent disagreement between the ECB and German leadership over the bank's new fiscal policies will be investigated.

In addition to Germany's interaction with the European Central Bank, consideration must be given to the country's connection with the other Eurozone states. This discussion will include an analysis of the differences in the economic mentality between Germany and the periphery states, and how this divergence has led to current conditions. The monetary assistance that the German nation state has rendered to the weaker member states has been somewhat ungratefully received due to the inclusion of required austerity measures. This examination will highlight the political repercussions of the ongoing economic crisis.

Next, the domestic benefits and consequences of Eurozone membership and the effects from the continuing financial crisis will be examined. Germany has experienced superior productivity growth and lower labor costs in relation to the weaker member states. The country enjoys current account surpluses and moderate Gross Domestic Product (GDP) per capita growth, in large part due to the inclusion of the diverse economies within the monetary union. This has given the German nation state an economic benefit that it would not have realized as a separate country.

Finally, the most important issue for the future of the Eurozone is Germany's decision to stay in or to exit the Union. Either choice will have consequences beyond the

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<sup>4</sup> Mario Draghi, "Introductory Statement to the Press Conference (with Q&A)," European Central Bank, August 2, 2012, <http://www.ecb.int/press/pressconf/2012/html/is120802.en.html>.

nation state and will have a profound impact for decades to come. Historical factors and current influences will both be discussed for the two choices available to Germany.

Given the literature review conducted, the hypothesis submitted is as follows: Due to the ingrained memories of the violent history of the country and the subsequent beliefs that arose in the aftermath, the government of the Federal Republic of Germany has undertaken the leadership role and has become the cornerstone for Eurozone monetary stability, and will continue this role until long-term stability prevails.

#### **D. LITERATURE REVIEW**

An examination of the Federal Republic of Germany in the post-World War II era provides insight into the country's conservative economic behavior. Two books provide a comprehensive study of Germany's success following the Second World War. These include Patrick Boarman's *Germany's Economic Dilemma: Inflation and the Balance of Payments*, published in 1964, and William Wadbrook's *West German Balance-of-Payments Policy: The Prelude to European Monetary Integration*, released in 1972.<sup>5</sup> These books discuss the Federal Republic of Germany's monetary and fiscal policies that were created to fervently combat inflation and address the early challenges of a balance of payments surplus. The authors also discuss the goals and policy interests of the German financial sector, including the long-term potential impact, and the mentality of government and Bundesbank leadership that continues to resonate today.

Numerous books have recently been published detailing the causes and effects of the European financial crisis. As this issue is still transpiring, later books include the most recent political and economic measures that have been implemented and discuss the consequences of continuing relief packages. One such work, *Coping with Crisis: Government Reactions to the Great Recession*, which was published in 2012, starts at the broad perspective of examining the origins of the global economic crisis and quickly narrows down to the causes of Europe's sovereign debt crisis and the actions taken in

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<sup>5</sup> Patrick M. Boarman, *Germany's Economic Dilemma: Inflation and the Balance of Payments* (New Haven, CT: Yale University Press, 1964); William Pollard Wadbrook, *West German Balance-of-Payments Policy: The Prelude to European Monetary Integration* (New York: Praeger Publishers, 1972).

response.<sup>6</sup> This book discusses the Eurozone recovery plan initiated at the institutional level, but also succinctly discusses the choices that Germany was presented with and the decisions the country has made in response. The last two chapters of the book provide a valuable insight into the consequences of the debt crisis, present the political opportunities that have been created, and discuss the underlying negative effect of the welfare state that is prevalent within the peripheral Eurozone countries.

Raymond Converse's *Fiscal Crisis and World Order*, which was published in 2012, provides a valuable insight into how the debt crisis currently affects the European Union and provides some alternative outlooks of what the Eurozone may look like after the crisis has passed.<sup>7</sup> The book provides a comprehensive examination of the multiple relief packages enacted to date in the attempt to combat the debt crisis. In addition, the book discusses the constraints of the existing treaties and the underlying weaknesses within the political systems of the peripheral states that currently hamper an expeditious recovery. As the author astutely states, "The solution in the case of the EU...will be found in some combination of disciplined spending behavior, increased revenue production from a couple of different sources, and a rational program for the stimulation of the economy."<sup>8</sup> The book also discusses the implications if Germany were to exit the Eurozone and introduces the distinct possibility of an undesirable Russian-German partnership.

Another comprehensive piece on the economic and political aspects of the Eurozone crisis is Matthew Lynn's book *Bust: Greece, the Euro, and the Sovereign Debt Crisis*, which was published in 2011.<sup>9</sup> This work incorporates a solid background of the formation of the economic union and discusses the fundamental weaknesses inherent within the ensuing treaties. In addition, the book discusses the relationships within, and between nations, that have contributed to the current crisis. This book also has a

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<sup>6</sup> Nancy Bermeo and Jonas Pontusson, eds., *Coping with Crisis: Government Reactions to the Great Recession* (New York: Russell Sage Foundation, 2012).

<sup>7</sup> Raymond W. Converse, *Fiscal Crisis and World Order* (New York: Algora Publishing, 2012).

<sup>8</sup> Ibid., 92–93.

<sup>9</sup> Matthew Lynn, *Bust: Greece, the Euro, and the Sovereign Debt Crisis* (Hoboken, NJ: John Wiley & Sons, Inc., 2011).

thorough account of the behind-the-scenes political negotiations that produced the initial rescue packages and devotes a chapter to understanding the German perspective, including discussing its past experiences and its current beliefs and economic principles. The author also proposes the need to disband the Eurozone and discusses what the global economy would look like if this occurs.

The Eurozone sovereign debt crisis can also be studied from a government perspective outside the European Union. The United States publishes research conducted for the U.S. Congress, via the Congressional Research Service (CRS), and releases transcripts and prepared statements from Congressional Hearings. Two valuable CRS reports include “The Eurozone Crisis: Overview and Issues for Congress,” released on 25 March 2013, and “Sovereign Debt in Advanced Economies: Overview and Issues for Congress,” released on 31 January 2013. In addition, recent pertinent Congressional Hearings include “The Future of the Eurozone: Outlook and Lessons,” before the Senate Subcommittee on European Affairs, convened on 1 August 2012, and “The Eurozone Crisis: Destabilizing the Global Economy,” before the House Subcommittee on Europe and Eurasia, conducted on 27 October 2011. These reports and testimony convey a plethora of background information, current statistics, and expert opinions of what caused the debt crisis and what are the current political dynamics and future prospects for the Eurozone. These resources also shed insight into various prominent U.S. political leaders’ perceptions of the crisis, including future Secretary of State and then Senator John Kerry’s remarks, and the opinions of the chairman and leading members of both subcommittees.

Another source that provides a current examination of the Eurozone crisis includes the National Bureau of Economic Research (NBER), a nonprofit, nonpartisan economic research organization that releases the NBER working paper series. The first relevant paper is “Fiscal Devaluations,” which examines other conventional fiscal instruments that may be utilized when a country cannot devalue its exchange rate. This component is a main constraint for euro currency countries in the continuing sovereign debt crisis, as nations such as Greece and Italy cannot devalue their currency to help improve their fiscal position. This paper introduces the option for a uniform increase in

import tariffs and export subsidies, and the prospect for a value-added tax increase and a uniform payroll tax reduction. The political complications of implementing these policies are discussed, as well as the value of Germany pursuing these measures in relation to the agreement of future relief packages. Another applicable paper is “A Tale of Politically-Failing Single-Currency Area,” which aptly describes the causes of the Eurozone crisis and details the unique constraints of a “politically weakly integrated system.”<sup>10</sup> This article discusses the supranational aspect of the Eurozone and the limitations that member states have in conducting fiscal policy. The paper also analyzes the political aspects of the unintended power that the European Central Bank has over member states.

Other applicable research organizations that publish relevant Eurozone articles include the *German Economic Review* and *Deutsche Bank DB Research*. The article “Controlled Dismantlement of the Eurozone: A Strategy to Save the European Union and the Single European Market,” released in 2013, addresses the problems with a single currency in Europe and the political consequences that may occur when member countries attempt to pursue internal devaluation. The article gives a succinct explanation of the factors that led to the debt crisis and presents solid arguments, and counter-arguments, for a dismantlement of the Eurozone. *DB Research*, under its “Focus Germany” research theme, has produced valuable and timely articles, including “Euro crisis brings economy to a standstill in the winter half,” and “Gradual improvement in 2013.” Both of these articles provide critical economic statistics and present current trends and future forecasts for the country. The article “Germany at the Polls: The 2013 Elections and the Future of the Euro” delivers an in-depth analysis of the current political situation in Germany and discusses the policy implications of different coalitions coming to power in the elections scheduled for fall 2013.

In addition to economic institutions, two important resources that will provide insight into German foreign policy issues are The German Council on Foreign Relations

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<sup>10</sup> Assaf Razin and Steven Rosefielde, “A Tale of Politically-Failing Single-Currency Area” (working paper, National Bureau of Economic Research, Cambridge, MA, 2012), 124, <http://www.nber.org/papers/w18352>.

(DGAP) and the German Institute for International and Security Affairs (SWP). Both of these sources provide analytical papers and promote public debate on current German issues and include numerous articles on the current sovereign debt crisis. These two sources will provide a German perspective on the political aspect of the Eurozone crisis.

A final noteworthy institutional publication is the annual *Transatlantic Trends* survey released by the German Marshall Fund of the United States. The 2012 edition includes a critical assessment of the European economy and the continuing euro crisis, and discusses the upcoming economic and foreign policy challenges for the continent. The issue also includes an insight into the public opinion of the euro and the approval levels of the economic and political institutions within the Union.

A vast resource of current material is also available from leading economic news agencies, including the *Financial Times*, *The New York Times*, and *Bloomberg BusinessWeek*. These news outlets include daily stories on current economic and political events in European nations and frequently include articles on the Eurozone crisis. In addition, the editorial sections of these newspapers include opinion pieces written by leading European officials and business leaders, such as an article composed by Wolfgang Schäuble, the German finance minister, in the *Financial Times* in 2010, and a piece written by George Soros, the hedge fund pioneer who caused the collapse of the Bank of England, also in the *Financial Times* in 2010.<sup>11</sup> Numerous articles covering a vast array of current German and Eurozone topics will be cited in this thesis.

## **E. METHODS AND SOURCES**

This thesis contains a case study of why Germany has undertaken the leadership role in the Eurozone sovereign debt crisis. In determining the motives for this action, a historical study will be conducted to examine the country's economic experiences during the early part of the twentieth century and the steps the country took after World War II to become an economic leader in Europe. This work will also include a comparative study between Germany and the other nations in the Eurozone, to determine what the

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<sup>11</sup> John Authers, *Europe's Financial Crisis: A Short Guide to How the Euro Fell into Crisis and the Consequences for the World* (Upper Saddle River, NJ: FT Press, 2013), 16–17.



peripheral nations did to get themselves into the current unsustainable debt situation and what Germany has sacrificed so far in the attempt to restore economic order. In examining this comparison, political and economic trends should surface that will demonstrate what Germany has done correctly so far and what they must sacrifice in the future to ensure European financial stability.

As research continues on this topic, additional primary sources will become valuable references of study. These will include official German government and European institutions' websites that include transcripts of speeches and policy press releases. Such reference sources include the German Federal Government and the German Missions in the United States websites, the Eurozone Portal, the European Council site, the European Stability Mechanism website, and the European Central Bank homepage. In addition, the need to frequently review the sources in this section, and those in the literature review section, will be vital to continually evaluate changing economic and political policy.

## **F. THESIS OVERVIEW**

To understand Germany's political decisions since 2007 regarding the Eurozone crisis, a historical review of economic actions and policy will be conducted and an evaluation of current economic institutions will be performed. In addition, Germany's relationship with Eurozone members and the response the country received after the first round of rescue packages will be studied. Once these historical and external factors are examined, an analysis of Germany's current economic and political state of affairs may be explored. After investigating the country's motives for the contributions and sacrifices it has made to date for the Eurozone crisis, a discussion may follow regarding future German options. Most notably, this will include an analysis if the country should continue in or exit the Eurozone and the possible consequences of each option.

In keeping with this theme, this thesis opens with an introduction of the current state of the Eurozone crisis and why it is as much about politics as it is about economics. The second chapter will discuss a history of European economic integration, to include the various treaties, unions, and pacts that have been ratified throughout the post-World

War II period. This chapter will then examine what the Eurozone periphery member states did to contribute to the crisis. The third chapter will discuss the current Eurozone crisis, to include a detailed account of the sovereign bailouts enacted to date and the financial aid packages that have been created to combat the crisis. This chapter will also discuss the continuing role of the “Troika,” which is comprised of the European Commission, the International Monetary Fund, and the European Central Bank, and the vital role that these institutions play in this crisis. This section will include the ECB’s objectives and limitations that were intentionally setup for the bank at its creation, and will discuss the role that Germany had in its formation. This discussion will include an evaluation of the Securities Market Programme (SMP) and the Outright Monetary Transactions (OMT) program that the European Central Bank initiated in response to the crisis.

The fourth chapter will discuss the German nation state, dividing the examination into the historical aspect and experiences of the country in the twentieth century, and the current role the nation has found itself in as a result of the ongoing economic situation. This chapter will examine the critical period of the 1950s, the age of German reunification, and the conditions created after the implementation of the euro. This section will also discuss the role of German institutions, including the Bundesbank, and the evolving role of German leadership and the nation’s citizens. The fifth chapter will discuss the options currently available to help resolve the ongoing sovereign debt crisis and the advantages and drawbacks of each alternative. This will be followed with an evaluation of whether Germany should stay in or exit the Eurozone. The economic and political ramifications of both options will be discussed, as well as the impact on the international community. This will be followed with a conclusion that will reinforce the decision that Germany should remain in the Eurozone. This chapter will include topics for reflection, to include the relevance of the Eurozone crisis on the United States and the increasing threat to European stability triggered by the rise in Eurozone unemployment. This section will also include a discussion of what should be done so that this type of economic tragedy does not happen again in the future.

## **II. THE ROADMAP TO THE EUROZONE CRISIS**

This chapter will discuss the historical evolution that culminated in the creation of the Eurozone circa 1999. This progression will be examined in terms of the treaties and pacts that the nation states agreed upon in the post-World War II period. In addition, the underlying social and economic complications among the weaker member states, which have now become apparent in the throes of the crisis, will be addressed. The euphoria present in the possible political and economic advancements that could be achieved in the post-World II era created an environment where agreements were made and possible negative consequences were overlooked, all in favor of the potential future for the European continent.

As with many defining incidents of the past, whether they brought social and political upheaval, such as those instigated by the French Revolution, or economic calamity, as witnessed with the Great Depression, the ultimate event was the culmination of cascading actions and choices consciously and unconsciously made over a period of time. King Louis XVI may have made different decisions prior to 1789 if he knew those choices would ultimately lead to his death a short time later. In this same approach, the U.S. Federal Reserve may not have contracted the money supply if it knew what would happen in 1929. The current Eurozone sovereign debt crisis may be observed in this same manner. One must consider if the 17 current Eurozone members would readily surrender sovereign monetary policy decisions and join an economic and monetary union if they knew this merger would fuel a crisis within a decade of its establishment? But this is exactly what these nation states did, and what they now fight to preserve.

### **A. EUROPEAN TREATIES**

Following World War II, Western leaders quickly realized that greater Western European integration would be necessary to break the continuous cycle of over five centuries of war. To this end, Jean Monnet, a French political and economic adviser, arose to become a leader in the effort to bring former enemies, specifically France and Germany, closer together through economic integration. His cause was the inspiration

behind the Schuman Plan, drafted by French foreign minister Robert Schuman in 1950, which proposed to create a common European institution that would manage the coal and steel industries of Western Europe. These industries were identified as an essential ingredient for a domestic military buildup, as was witnessed in Germany in the years prior to World War II. The Schuman Plan was presented on 9 May 1950, a date that is now regarded as the birth of the European Union and one that is annually celebrated as “Europe Day.” On 18 April 1951, West Germany, France, Italy, the Netherlands, Belgium, and Luxembourg signed the Treaty of Paris, which formally established the European Coal and Steel Community (ECSC). This treaty also included the signing of the Europe Declaration, an agreement where the six members pledged their commitment to the first model of a supranational organization in Europe; a new concept where negotiated state power is surrendered to a higher authority. This new authority consisted of an Assembly, a Council of Ministers, a High Authority, and a Court of Justice. On the outside, the ECSC formed an economic union that controlled the vital raw materials needed to manufacture arms, but more significantly it designed the initial institutions necessary for a new political union between former enemies, and as a result, created the foundation for European integration.<sup>12</sup>

The Messina Conference of June 1955 introduced the next major step toward European integration that culminated with the creation of the European Economic Community (EEC). This conference endeavored to reverse the failure to implement the European Defence Community (EDC) in 1954, and to build upon the accomplishments realized with the ECSC. In this effort, a series of meetings took place that culminated with the proposal to create a general common market and an atomic energy community.

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<sup>12</sup> Andrew C. Sobel, *International Political Economy in Context: Individual Choices, Global Effects* (Washington, DC: CQ Press, 2013), 474, 477; Johan Van Overtveldt, *The End of the Euro: The Uneasy Future of the European Union* (Chicago: Agate Publishing, 2011), 19; “The History of the European Union,” European Union, accessed April 17, 2013, [http://europa.eu/about-eu/eu-history/index\\_en.htm](http://europa.eu/about-eu/eu-history/index_en.htm); Christopher Alessi, “The Eurozone in Crisis,” Council on Foreign Relations, last modified April 3, 2013, <http://www.cfr.org/eu/eurozone-crisis/p22055>.

These two proposals were agreed upon in March 1957, with the signing of the Treaty of Rome, which formally established the EEC and the European Atomic Energy Community (Euratom).<sup>13</sup>

The Treaty of Rome is noteworthy in that it demonstrated the ability for the six original member states to overcome the failure of the recent defense initiative and agree upon a supranational collaboration dealing with economic reforms. This allowed for the progression of European unity during a period of increased French conviction over national sovereignty and allowed for Germany and France to continue down the path of reconciliation. As the preamble of the treaty declares, it is “determined to lay the foundations of an ever-closer union among the peoples of Europe, resolved to ensure the economic and social progress of their countries by common action to eliminate the barriers which divide Europe.”<sup>14</sup> This treaty served as a baseline for groundbreaking future agreements that are subsequently created as amendments to the Treaty of Rome. These include the Single European Act of 1986, the Maastricht treaty of 1992, and the 2007 Treaty of Lisbon. The Treaty of Rome, and the creation of the EEC and the Common Market, ushered in an era of growth as trade tariffs were removed and joint production initiatives were increased.<sup>15</sup>

The next essential step towards a greater degree of integration was The Single European Act (SEA), signed in 1986, and which entered into force on 1 July 1987. In the three decades since the creation of the EEC, membership had grown to 12 nations, with the inclusion of Denmark, Greece, Spain, Ireland, Portugal, and the United Kingdom. The primary intent of this pact was to transform the Common Market into an internal European market, allowing for the free movement of goods, persons, services, and capital. As the preamble of the SEA affirms, this treaty is “determined to improve the economic and social situation by extending common policies and pursuing new

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<sup>13</sup> “Treaty Establishing the European Economic Community, EEC Treaty,” European Union, accessed April 17, 2013, [http://europa.eu/legislation\\_summaries/institutional\\_affairs/treaties/treaties\\_eec\\_en.htm](http://europa.eu/legislation_summaries/institutional_affairs/treaties/treaties_eec_en.htm).

<sup>14</sup> “The Treaty of Rome,” European Commission, March 25, 1957, [http://ec.europa.eu/economy\\_finance/emu\\_history/documents/treaties/rometreaty2.pdf](http://ec.europa.eu/economy_finance/emu_history/documents/treaties/rometreaty2.pdf).

<sup>15</sup> “Treaty Establishing the European Economic Community, EEC Treaty.”

objectives, and to ensure a smoother functioning of the Communities.”<sup>16</sup> The original model for this act was drafted by Hans Dietrich Genscher, the German Minister for Foreign Affairs, and his Italian counterpart, Emilio Colombo. This opening of state borders highlighted the need for monetary coordination between members and continued the trend towards economic and political integration.<sup>17</sup>

The Treaty on European Union (TEU), signed in Maastricht, the Netherlands, on 7 February 1992, ushered in a framework for the post-Cold War era in Europe. The agreement, now universally recognized as the Maastricht treaty, was motivated at the time of conception by a possible German reunification and the desire to enhance the Single European Act. With the objective to introduce a new phase in European integration, the treaty introduced multiple new concepts for the member states. First, the European Economic Community, which had persisted since 1957, became the European Community (EC) to highlight the inclusion of a political integration. Second, the newly labeled European Union (EU) was assembled around three pillars: the European Communities, a Common Foreign and Security Policy (CFSP), and new police and judicial cooperation among member states. Next, the treaty created the novel concept of European citizenship over and above national citizenship and expanded the supranational powers of the European Parliament. Finally, and most notably, the Maastricht treaty shaped the final stages of the Economic and Monetary Union (EMU), which introduced the euro currency to the European Union. As a result, the Maastricht treaty accelerated the continuing ideals of European integration and formed the criteria for membership into the Eurozone.<sup>18</sup>

The establishment of the European Union in the Maastricht treaty combined previous initiatives and introduced new ones. The European Communities pillar merged the newly christened European Community with the European Coal and Steel

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<sup>16</sup> “The Single European Act,” European Commission, February 17, 1986, [http://ec.europa.eu/economy\\_finance/emu\\_history/documents/treaties/singleeuropeanact.pdf](http://ec.europa.eu/economy_finance/emu_history/documents/treaties/singleeuropeanact.pdf).

<sup>17</sup> “The Single European Act,” European Union, accessed April 19, 2013, [http://europa.eu/legislation\\_summaries/institutional\\_affairs/treaties/treaties\\_singleact\\_en.htm](http://europa.eu/legislation_summaries/institutional_affairs/treaties/treaties_singleact_en.htm); Alessi, “The Eurozone in Crisis.”

<sup>18</sup> “Treaty of Maastricht on European Union,” European Union, accessed April 19, 2013, [http://europa.eu/legislation\\_summaries/institutional\\_affairs/treaties/treaties\\_maastricht\\_en.htm](http://europa.eu/legislation_summaries/institutional_affairs/treaties/treaties_maastricht_en.htm).

Community and the European Atomic Energy Community. This new enterprise was formed around the fledgling concept of a supranational balance of powers, with the European Commission submitting proposals, the European Parliament and European Council approving decrees, and the Court of Justice monitoring compliance of passed measures. The CFSP pillar builds upon the appeal introduced in the Single European Act for member states to work together on foreign policy, as it creates a program that promotes joint foreign policy. The third pillar expands the joint law enforcement capabilities for member states in an attempt to provide a new level of protection for the European citizen who may move freely around the EU. These three pillars functioned to increase the political dimension of the new treaty.<sup>19</sup>

The freshly minted Economic and Monetary Union created a three stage progression for European Union countries to enter the Eurozone. The first stage, which commenced on 1 July 1990, removed all restrictions on the movement of capital between member states. In addition, the member's central banks increased their cooperation on monetary policies with the intent of achieving price stability within the union. The second stage, which began on 1 January 1994, commenced with the establishment of the European Monetary Institute (EMI), which was a precursor to the European Central Bank (ECB). The EMI was tasked with strengthening central bank cooperation and monetary policy coordination, and to make preparations for a single monetary policy. During this phase, the euro was named, exchange rates with non-participating EU members were negotiated, and conversion rates for euro members were agreed upon. In addition, the Stability and Growth Pact (SGP) was adopted in June 1997, and the initial members who qualified for the Eurozone were announced. Lastly, the European Central Bank was established on 1 June 1998, and operations were transferred from the EMI to the ECB. In the 1990s, as the wickets of success were being checked off for the first two stages of the EMU, a fundamental flaw regarding membership into the third stage was being glossed over, one that would be exposed during the first sign of monetary hardship.<sup>20</sup>

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<sup>19</sup> Ibid.

<sup>20</sup> "Economic and Monetary Union (EMU)," European Central Bank, accessed April 20, 2013, <http://www.ecb.int/ecb/history/emu/html/index.en.html>.

The third stage of the EMU commenced on 1 January 1999, with the introduction of the euro. On this day, the exchange and conversion rates were locked into place and the ECB took over coordination of a single monetary policy for the Eurozone. On 1 January 1999, 11 European Union states qualified for the third EMU stage and became founding members of the Eurozone: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. Two additional European Union members, the United Kingdom and Denmark, qualified for Eurozone membership but declined. Six additional nation states have since met the requirements for membership: Greece joined on 1 January 2001; Slovenia became the 13th member on 1 January 2007; Cyprus and Malta qualified on 1 January 2008; Slovakia became the 16th member one year later; and Estonia joined on 1 January 2011. This brings the current Eurozone membership to 17 of the 28 EU member states. All members of the European Union, with the exception of the U.K. and Denmark, are expected to join the Eurozone. The remaining nine members continue to receive deferments until they fulfill the necessary economic and legal requirements for membership.<sup>21</sup>

Acceptance into the third stage of the EMU is based upon fulfilling the four conditions listed in the Maastricht criteria, also regarded as the convergence criteria. Candidate EU members are tasked with meeting the four economic and financial conditions, which include a high degree of price stability, the sustainability of government finances, participation in the Exchange Rate Mechanism of the European Monetary System, and the durability of long-term interest rate levels.<sup>22</sup> The benchmarks for these criteria were ultimately negotiated as follows: inflation could not exceed that of the three best performing member states by more than 1.5 percent a year; budget deficits must be no more than three percent of GDP; candidates must maintain a debt-to-GDP

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<sup>21</sup> “Economic and Monetary Union (EMU);” “Treaty of Maastricht on European Union;” “Third Stage of Economic and Monetary Union,” European Union, accessed April 20, 2013, [http://europa.eu/legislation\\_summaries/economic\\_and\\_monetary\\_affairs/introducing\\_euro\\_practical\\_aspects/ec0015\\_en.htm](http://europa.eu/legislation_summaries/economic_and_monetary_affairs/introducing_euro_practical_aspects/ec0015_en.htm).

<sup>22</sup> “The Maastricht Treaty: Provisions Amending the Treaty Establishing the European Economic Community With a View to Establishing the European Community,” European Commission, February 7, 1992, 24, <http://www.eurotreaties.com/maastrichtec.pdf>.



ratio of less than 60 percent; and long-term interest rates must not be greater than two percent above the average of the three best performing member states.<sup>23</sup>

As the EU leadership pressed to add nation states to the Eurozone, various aspects of the convergence criteria were disregarded for potential membership, while other candidates falsely reported financial data to create favorable statistics. In this economic boom period of the new century, the negative long-term potentials were simply disregarded for the short-term economic and political gains. In this era, living standards were dramatically increasing and an aura of European cooperation and potential economic dominance was prevailing. On the day the Eurozone began, two of the 11 members, Belgium and Italy, had debt-to-GDP ratios above the allowed 60 percent threshold. Two years later, Greece was permitted admission with a debt ratio above the maximum allowed. In addition, in December 2009, recently elected Greek Prime Minister George Papandreu announced that the former government had under-reported its budget deficit figures to help gain stage three entry. In this infancy stage of the Eurozone, politicians chose to focus on the chance for success rather than make the rational decisions that may have avoided the future crisis.<sup>24</sup>

In a well-intentioned effort to ensure that EMU members maintain fiscal discipline and preserve the monetary stability of the Eurozone, the EU passed the Stability and Growth Pact. German finance minister Theo Waigel initially proposed the SGP in an attempt to limit the inflationary pressure that members could exert on the Eurozone. This agreement created a monitoring and enforcement mechanism for the EMU, through the passage of the “preventive arm” regulation, enacted on 1 July 1998, and the “corrective arm” regulation, which entered into force on the opening day of the Eurozone. Since all members of the European Union are enrolled in the EMU, they all are also legally obligated to the SGP, as defined in the Treaty on the Functioning of the European Union (TFEU). This pact enforces key aspects of the convergence criteria,

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<sup>23</sup> “The Eurozone in Crisis;” “Introducing the Euro: Convergence Criteria,” European Union, accessed April 20, 2013, [http://europa.eu/legislation\\_summaries/economic\\_and\\_monetary\\_affairs/institutional\\_and\\_economic\\_framework/ec0013\\_en.htm](http://europa.eu/legislation_summaries/economic_and_monetary_affairs/institutional_and_economic_framework/ec0013_en.htm).

<sup>24</sup> Ivan T. Berend, *Europe in Crisis: Bolt from the Blue?* (New York: Routledge, 2013), 17–18.

including the maintenance of budget deficits to no more than three percent of GDP, and the preservation of a debt-to-GDP ratio of less than 60 percent. A higher debt ratio that is noticeably declining towards the 60 percent limit is also acceptable. Member states are obligated to submit an annual report on compliance, while the European Commission and the Council of Ministers are tasked with monitoring the fiscal conditions of Eurozone members. If a country is out of compliance, the SGP calls for an Excessive Deficit Procedure (EDP) to be enacted to assist the member back into compliance, and if this is deemed as unsuccessful, economic sanctions may be imposed. The Stability and Growth Pact created the rules and identified the consequences if they were not followed, but unfortunately it did not create a mentality to enforce those rules when they were soon broken.<sup>25</sup>

In the period prior to the Eurozone crisis, the Council of Ministers and the European Commission knowingly overlooked multiple violations of the SGP. In 2004, the overall debt-to-GDP ratio of the EU was 62.4 percent and increased to 63.4 percent in 2005.<sup>26</sup> In 2007, in the months prior to the onset of the financial crisis, the debt ratio for Greece was 105 percent, while Italy had a debt ratio of 106 percent. At the same time, Portugal's ratio had climbed to 68 percent, Germany's reached 65 percent, and France realized 64 percent government debt. Before the crisis hit, 25 of the 27 EU members violated the 60 percent limit agreed upon for Eurozone entry, and which was allowed per the Stability and Growth Pact.<sup>27</sup> As Jason Manolopoulos succinctly surmises, "There was shockingly weak due diligence in assessing suitability for entry into the euro, and an equally weak application of the few rules that were supposed to police its operation."<sup>28</sup>

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<sup>25</sup> "Stability and Growth Pact," European Commission, accessed April 24, 2013, [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/index\\_en.htm](http://ec.europa.eu/economy_finance/economic_governance/sgp/index_en.htm).

<sup>26</sup> "Revising the Stability and Growth Pact: Public Finances in EMU 2006," European Union, accessed April 24, 2013, [http://europa.eu/legislation\\_summaries/economic\\_and\\_monetary\\_affairs/stability\\_and\\_growth\\_pact/125084\\_en.htm](http://europa.eu/legislation_summaries/economic_and_monetary_affairs/stability_and_growth_pact/125084_en.htm).

<sup>27</sup> Berend, *Europe in Crisis*, 17.

<sup>28</sup> Jason Manolopoulos, *Greece's "Odious" Debt: The Looting of the Hellenic Republic by the Euro, the Political Elite and the Investment Community* (New York: Anthem Press, 2011), 163.

This era of continued economic gains and an unprecedented liquidity boom created the mentality that these limits could be violated as long as growth and prosperity prevailed.<sup>29</sup>

The Treaty of Lisbon, signed on 13 December 2007, signified a political compromise between the 27 EU member states in the wake of the failure to ratify a European Constitution. The supranational Constitution, which the member states' leadership approved and signed on 29 October 2004, ultimately failed at the national level in the ratification process, and in doing so, extinguished the greatest opportunity for a United States of Europe. As an alternative to a broad constitutional treaty, EU leaders instead amended the Treaty of Rome and the Maastricht treaty to create the new Treaty of Lisbon. This new agreement entered into force on 1 December 2009, and introduced sweeping reforms to the structure and the functions within the EU. The treaty created "a more democratic and transparent Europe; a more efficient Europe; a Europe of rights and values, freedom, solidarity and security; and a Europe as an actor on the global stage."<sup>30</sup> From an economic perspective the treaty designated the European Central Bank as an official EU institution, strengthened the supervisory role of the commission, and specified that only Eurozone members may decide EU monetary policy matters. These amendments created a focal point for decision-making from which further reforms will be necessary to resolve the Eurozone crisis.<sup>31</sup>

## **B. THE FAULTS OF THE NATION STATE**

The constraints and inadequacies of the treaties enacted before the Eurozone sovereign debt crisis present only one-half of the overall equation that created an environment susceptible to fiscal crisis. The second part rests on the political and economic decisions that the nation states of Europe made in this period. With one proclamation, the Eurozone brought together nations that incorporated a wide diversity of history, cultures, and beliefs that have been ingrained into the populaces over an

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<sup>29</sup> Edwin M. Truman, "Unraveling the Euro Crisis," Peterson Institute for International Economics, January 26, 2012, <http://www.piie.com/publications/papers/paper.cfm?ResearchID=2035>.

<sup>30</sup> "The Treaty at a Glance," European Union, accessed April 24, 2013, [http://europa.eu/lisbon\\_treaty/glance/index\\_en.htm](http://europa.eu/lisbon_treaty/glance/index_en.htm).

<sup>31</sup> "Economic and Monetary Policy," European Union, accessed April 24, 2013, [http://europa.eu/legislation\\_summaries/institutional\\_affairs/treaties/lisbon\\_treaty/ai0031\\_en.htm](http://europa.eu/legislation_summaries/institutional_affairs/treaties/lisbon_treaty/ai0031_en.htm).

expansive timeline. In addition, many of these nation states were exposed to new and recently unimaginable economic prospects. Politicians, capitalists, and later ordinary citizens hastily embraced the new opportunities placed before them, many times without understanding the full fiscal consequences of their actions. As a result, when an unanticipated obstacle moved in front of the Eurozone economic train, it did not have the brakes or distance to stop before impact.

The economic crisis immediately caused problems for those nation states located on the periphery of the union, and as such, soon created a division within the Eurozone of those states at the “core,” which exhibited greater financial stability, and those nations on the “periphery,” which did not. These core countries were soon identified as Germany, France, Belgium, and the Netherlands, while the periphery states included Greece, Ireland, Italy, Portugal, and Spain (GIIPS). The periphery states have unique, but at times, similar circumstances and economic policies that led to crisis.

The Greek crisis has roots in a historical aspect but also stems from symbolic modernization projects that the country undertook. The non-industrialized Balkan country, with its strategic location in Southeast Europe, was readily accepted into the post-World War II European community as a counter to the spread of communism. The country joined the EEC in 1981, with a national income level that had only reached 64 percent of the Western European average. In the years that followed, Greece attempted to hastily grow its economy in an effort to become an equal on the European stage, all while contending with a deep tradition of corruption, cronyism, and tax evasion. The country also rapidly created and expanded its welfare system, and at the same time, reduced the retirement age to 58 years and installed full pensions for 35 years of service. For those employed, wages rose five percent annually, a rate twice as fast as the EU average. As a result, from 2000 to 2008, government expenditures increased by 87 percent, while revenues increased only 31 percent. To offset the difference, Greece

turned towards borrowing large sums of money, which was revealed as the nation's public debt reached 160 percent of GDP in January 2012.<sup>32</sup>

The 2004 Athens Olympics also created a severe economic hardship for Greece that served as a catalyst for economic disaster. The original budget for the games was set at €2.5 billion, but once construction began, it was increased to €4.6 billion. In addition, €1.3 billion was allocated to modernize the city's transportation system for the event and €600 million was assigned to build the Olympic village. As the opening ceremonies began, the cost of the games had skyrocketed to €10 billion and consumed four percent of the Greek GDP. More significantly, in order to pay for the event, the country borrowed the money from foreign lenders. This catapulted the country's national debt and repayment responsibilities.<sup>33</sup>

In contrast to Greece, Ireland's economic troubles originated in the private sector, through irresponsible borrowing and spending, and with an unsustainable real estate market. Ireland joined the EEC in 1973, in a period when the country trailed behind other modernizing European nations, and at a time when the country heavily depended upon Britain for economic support. This era witnessed a per capita GDP that totaled only 37 percent of the EEC average. Upon entry into the Community, foreign direct investment (FDI) propelled the country from a laggard to a leadership position as the economy was modernized and export-focused industry rapidly expanded. This success quickly led to an increase in personal income and created new economic fortunes. By 2005, the per capita GDP for Ireland had surpassed the Eurozone average by 53 percent, creating an unprecedented "rags to riches" scenario for the country.<sup>34</sup>

As with any rapid increase in disposable income, the populace is confronted with two choices for their earnings, either save it or spend it. Irish citizens decided to spend

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<sup>32</sup> Thomas J. Schoenbaum, *The Age of Austerity: The Global Financial Crisis and the Return to Economic Growth* (Northampton, MA: Edward Elgar Publishing, 2012), 11; Berend, *Europe in Crisis*, 15–16, 21.

<sup>33</sup> Berend, *Europe in Crisis*, 13–14.

<sup>34</sup> Otto Hieronymi and Constantine Stephanou, eds., *International Debt: Economic, Financial, Monetary, Political and Regulatory Aspects* (New York: Palgrave Macmillan, 2013), 116; Berend, *Europe in Crisis*, 22–23.

their new found wealth at unprecedented levels, focusing on the purchasing of new homes and increasing their consumption habits. As Ivan Berend notes, “People wanted to enjoy and exploit this great historical luck, and they started consuming and buying in a way that generations of Irish people had only dreamed about.”<sup>35</sup> This aspiration, coupled with artificially low interest rates and unlimited bank lending, created a huge building boom in the nation. At the same time, household debt increased dramatically, climbing from 60 percent to 160 percent of GDP at the pinnacle before the crisis hit.<sup>36</sup>

Enduring regional differences within the country, and fiscal measures that got out of control, contributed largely to Italy’s sovereign debt crisis. Even after the nation was unified in 1861, the country continued to experience a fracture between the prosperous north, which experienced three percent annual growth before the crisis, and the lagging south, which declined two percent annually. Additionally, youth unemployment reached 40 percent in the southern region of Italy. Overall, for a majority of the period after the introduction of the euro, the country was caught in economic stagnation.<sup>37</sup>

To offset the lack of government revenues caused by a weak economy, Italian leaders resorted to borrowing money to run the country. Undeserving low yields and low interest rates on government bonds stoked the country’s borrowing policy that rapidly led to an increase in public debt. In the years preceding the introduction of the third stage of the EMU, the country’s debt-to-GDP ratio reached 120 percent. At the start of the Eurozone crisis, Italy had the world’s third-largest public debt level. As the crisis persisted, Italy’s public debt reached five times the size of the Greek debt and equaled three times the size of the combined Icelandic, Greek, and Irish debt levels.<sup>38</sup>

The Iberian Peninsula similarly contributed to the Eurozone crisis as a result of complications from within. The nation of Portugal also suffered from a weak economy prior to the introduction of the euro. In 1986, when the country joined the EEC, its per

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<sup>35</sup> Berend, *Europe in Crisis*, 23.

<sup>36</sup> Lynn, *Bust*, 69; Berend, *Europe in Crisis*, 22–24.

<sup>37</sup> Berend, *Europe in Crisis*, 32.

<sup>38</sup> Manuel Castells, Joao Caraca and Gustavo Cardoso, eds., *Aftermath: The Cultures of the Economic Crisis* (Oxford: Oxford University Press, 2012), 80; Berend, *Europe in Crisis*, 32–33.

capita GDP level was only 57 percent of the Community's average. At the start of the Eurozone, this level had only risen to 65 percent of the overall average. In addition, throughout the decade prior to the crisis, the nation's calculated purchasing power and global competitiveness index continually lagged behind the other EU countries.<sup>39</sup>

Portugal followed the same path taken by many nations during the 2000s, allowing its residents easy access to low interest borrowing and generous lines of credit. In this regard, the populace attempted to join the wave of increased European living standards with money it did not have. The Portuguese government also resorted to borrowing large sums of money to compensate for a sluggish economy. The country's debt-to-GDP ratio reached 76 percent in 2009, and continued to increase, reaching 112 percent in 2012. In another troubling economic sign, Portugal's budget deficit surpassed the three percent legal limit, reaching 9.4 percent in the summer of 2010.<sup>40</sup>

The contributing factors that led to the Spanish economic crisis stem from the regional autonomy that exists within the government structure and the rise in consumerism, which included an increase in the demand for real estate. The federal government did not show signs of distress as the country's debt ratio remained at 40 percent throughout 2007, and which later only increased to 53 percent by 2010. This suitable level was misleading as the 17 regions of the country were primarily responsible for costly government social programs, and as such, rapidly accumulated huge public deficits. By 2010, regional debt had reached \$114 billion, and only one year later, climbed to \$176 billion. In addition, the regional governments were responsible for the local banking sector and had to allocate large sums of money in an attempt to keep these institutions afloat. Even with the economic aid, this era witnessed 27 of these regional banks go into default.<sup>41</sup>

As witnessed in other EU countries, wages in Spain also climbed at unwarranted rates, which created excesses for consumer spending. The per capita GDP for the country

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<sup>39</sup> Berend, *Europe in Crisis*, 31.

<sup>40</sup> Castells, *Aftermath*, 156; Berend, *Europe in Crisis*, 31.

<sup>41</sup> Berend, *Europe in Crisis*, 34.

tripled in the three decades prior to the economic crisis and income levels rose from 50 percent to 81 percent of the Eurozone average. Comparable with Ireland, the populace of Spain also focused their new found wealth on buying homes. At the height of the real estate bubble in the late 2000s, 80 percent of Spaniards owned their own homes, while banks offered 40 and 50 year variable rate mortgages. In this period, the resultant real estate and construction industry rose to encompass 20 percent of Spain's GDP and employed one-sixth of the country's work force. This substantial focus on one sector contributed to the rapid rise in unemployment once the economic crisis hit. In the first quarter of 2013, unemployment in Spain reached 27.2 percent overall, while youth unemployment reached 45 percent. More astonishingly, these figures equate to over six million Spaniards who are recently out of a job.<sup>42</sup>

The imperfections residing in the post-World War II European treaties, and the overwhelming opportunities generated in the periphery nation states, created a recipe for disaster for the Eurozone. At times, the proper models for success were agreed upon and put into place, but were not universally applied. This was demonstrated by the failure to collectively enforce the four conditions required for entry into the third stage of the EMU and the ensuing Stability and Growth Pact. In this regard, politics triumphed over economic trepidations, and in doing so, created a dangerous precedence within the Union. At the same time, domestic lawmakers failed to regulate the out-of-control spending habits within their nations and instead participated in the easy access to money. The impact of the crisis would not have been so severe if Spanish regulators had halted 40 and 50 year mortgages or if Greek leaders had not resorted to massive borrowing to sustain their government. These and the other factors identified in the above chapter, ultimately led to the Eurozone sovereign debt crisis and created an environment where a previously war-torn country was forced to accept the responsibility to bailout the others.<sup>43</sup>

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<sup>42</sup> Berend, *Europe in Crisis*, 35; Tom Burridge, "Spain Unemployment Hits Record High," *BBC World News*, April 25, 2013, <http://www.bbc.co.uk/news/business-22290422>.

<sup>43</sup> Truman, "Unraveling the Euro Crisis."



### III. THE EUROZONE CRISIS

The financial calamity emanating from the United States provided the catalyst for a European economic crisis. In April 2007, New Century Financial, an American subprime mortgage company, filed for bankruptcy and in turn set off the U.S. subprime mortgage crisis. This event was followed with the high profile March 2008 government rescue of Bear Stearns and the subsequent decision to allow Lehman Brothers to go into bankruptcy in September 2008. In turn, the New York Stock Exchange responded with a 54 percent decline in value in less than one year. The nearly decade long practice of high-risk borrowing and lending, and the inevitable bursting of the worldwide real estate bubble, created an immediate domino effect that seized the globalized economy as in 1929.<sup>44</sup>

The subsequent economic crisis spawned massive financial bailouts around the world that included sizeable rescue packages within the Eurozone. In the ensuing years, the European Union, the International Monetary Fund (IMF), and the European Central Bank committed immense sums of money in an attempt to quell the crisis. These steps slowed the negative economic slide, but have not as of yet created a permanent solution. In addition, high levels of public debt and government deficits have persisted and weaknesses within the European banking system have been revealed. Finally, a continuing lack of economic growth, and persistent trade deficits in the periphery states, has accelerated a dangerous upsurge in regional unemployment and social unrest. As Robert Zoellick, President of the World Bank accurately observed in 2009, “What began as a great financial crisis and became a great economic crisis is now becoming a great crisis of unemployment.”<sup>45</sup>

This chapter will delve into the turmoil that ensued following the summer of 2007. The rescue packages that were assembled and distributed will be discussed, as well as the apparatuses created in response to the crisis. These include the European Financial

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<sup>44</sup> Berend, *Europe in Crisis*, 6; “Subprime Crisis: A Timeline,” *CNN Money*, September 21, 2008, [http://money.cnn.com/2008/09/15/news/economy/subprime\\_timeline/](http://money.cnn.com/2008/09/15/news/economy/subprime_timeline/).

<sup>45</sup> Bermeo, *Coping with Crisis*, 96; Berend, *Europe in Crisis*, 5.

Stability Facility (EFSF) and the European Stability Mechanism (ESM). The unanticipated repercussion of Eurozone members not having the ability to devalue their currency at the national level, and the shortcomings of austerity measures and structural reforms will be examined. In addition, the vital role of the Troika will be discussed, as will the evolving participation of the European Central Bank. This will include the treaty-enacted restrictions placed upon the ECB, as well as the political pressures emanating from the Eurozone leadership.

#### **A. SOVEREIGN BAILOUTS**

Upon reflection, the indicators of an impending financial crisis were clearly present in the Eurozone. The failure to react to these red flags highlights the power of the political will for this Union to prosper at any cost. In the period prior to the crisis, consumer borrowing and consumer debt expanded at a massive rate. Household expenditures increased at a pace never realized before on the European continent, as consumers and institutions poured in money to fuel the real estate bubble. While this was occurring, state governments increased their expenses while revenues decreased. To offset the difference, nation's simply borrowed money to compensate for the negative revenues. In some countries, public debts surpassed the entire value of the nation's GDP. In response, assurances were made and apathetic austerity measures were enacted to correct the imbalances. These only worked to reduce domestic demand and created barriers for much needed growth. As such, when lending dried-up and interest rates soared the situation rapidly deteriorated into a crisis. An examination of the financial crisis that ensued within each of the GIIPS countries follows. Additionally, the fiscal tragedy that spread from Greece to Cyprus is discussed.<sup>46</sup>

The Greek sovereign debt crisis exploded with the government's announcement of the false reporting of state finances. In December 2009, Prime Minister Papandreu revealed that the budget deficit and the public debt were more than twice what had been previously reported. Four months later, the EU Statistical Office announced that these new figures were still low and released a revised budget deficit for Greece of 13.6

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<sup>46</sup> Berend, *Europe in Crisis*, 5; Schoenbaum, *Age of Austerity*, 11.

percent. Credit rating agencies soon followed by downgrading Greece to an eventual “junk rate” level, which rapidly increased the interest rates on government bonds. In January 2010, two-year Greek bonds were being offered with a 3.47 percent interest rate. In July 2011, the interest rate on these type bonds increased to an unimaginable 26.65 percent.<sup>47</sup>

As a result of these unsustainable increases in interest rates and the decline in demand for Greek bonds, the government in 2010 could not meet its €50 billion in obligations. In May of that year, the Eurozone and the IMF provided the first rescue package to the country, which included strict austerity measures and demands for structural reforms. In response, the Greek government significantly increased existing tax levels, introduced new taxes, and restructured the level of tax-free incomes. Wages were cut in the public sector, in some instances as much as 40 percent, and in the private sector by 14 percent. The pension age in the country was increased and existing retirement payments were reduced by as much as 35 percent. As Ivan Berend notes, “The government became paralyzed and a deep political crisis emerged. Small and relatively far-away Greece shocked the entire European Union and the common currency.”<sup>48</sup> The resultant austerity measures produced violent public demonstrations in the country, as unemployment jumped to 36 percent, and caused a devaluation of the euro on the international market. The crisis also led to the resignation of Prime Minister Papandreu, and resulted in the creation of a new temporary coalition government.<sup>49</sup>

With strict austerity measures enacted and a deep recession continuing, Greece was once again unable to settle its debts in the first quarter of 2012. This time the country required €30 billion to repay maturing bonds. In March 2012, the Eurozone and the IMF provided Greece with an additional rescue package amounting to €40 billion. Once again, this provided the country with a stop-gap measure to prevent bankruptcy and temporarily prevented a possible withdrawal from the Eurozone.<sup>50</sup>

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<sup>47</sup> Berend, *Europe in Crisis*, 18.

<sup>48</sup> Ibid., 19.

<sup>49</sup> Berend, *Europe in Crisis*, 19–21; Schoenbaum, *Age of Austerity*, 40.

<sup>50</sup> Berend, *Europe in Crisis*, 21–22; Schoenbaum, *Age of Austerity*, 41.

Ireland's troubles began shortly before the U.S. financial crisis hit. In 2006, the rapid rise in housing prices finally exceeded what a majority of the populace could afford. In response, home prices immediately dropped 18 percent and continued in a steady decline downward. Once the global crisis hit, home prices fell 50 percent and bank stock prices declined by 90 percent. From April 2007 to February 2009, the Irish Stock Exchange plummeted over 80 percent. Predictably, unemployment rapidly increased, reaching 15 percent in 2009.<sup>51</sup>

In response to the economic calamity, Irish citizens rushed to the country's banks to withdraw their savings, and in doing so created two nationwide bank runs. The first, in 2008, resulted in the withdrawal of €4 billion in deposits, while the second in 2010, witnessed the removal of €67 billion from the banking system. The financial sector of Ireland was devastated. As a result, in December 2010, the Eurozone and the IMF coordinated a second rescue package, this time for the Irish banking system in the amount of €85 billion. Furthermore, the Irish government contributed an additional €64 billion towards the bank crisis. The Eurozone bailout agreement once again incorporated drastic austerity measures that deeply affected the country. In the end, the massive infusion of capital gradually improved the banking sector, and in 2012, the country showed signs of recovery.<sup>52</sup>

Portugal's economic difficulties came to an apex in the spring of 2011. In the year prior to the Portuguese crisis, the country continued to believe it could solve its own economic problems, as state officials insisted that they would not need a bailout like Greece. As the leadership held firm to this stance, public and private debt levels continued to rapidly increase and bond yields surged to unsustainable rates. As a result, credit rating agencies downgraded the government bonds to junk levels, which only increased the fiscal pressures to unmanageable levels.<sup>53</sup>

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<sup>51</sup> Berend, *Europe in Crisis*, 24–25.

<sup>52</sup> Philip B. Whyman, Mark Baimbridge and Andrew Mullen, *The Political Economy of the European Social Model* (New York: Routledge, 2012), 289; Berend, *Europe in Crisis*, 25–26.

<sup>53</sup> Berend, *Europe in Crisis*, 31.

The Portuguese government finally requested assistance after it could not meet its debt repayment options. In response, in May 2011, the Eurozone and the IMF bailed out Portugal with a €80 billion rescue package. This became the third Eurozone bailout in a one-year time period. As with the other two rescue packages, strict austerity measures and structural reform initiatives were also incorporated into the Portuguese bailout. These attached conditions forced an environment of internal dissension within the nation as lawmakers had already rejected an austerity plan presented by Prime Minister Jose Socrates in 2010. This previous debate became so contentious that it caused the Prime Minister to resign in defeat. Once again, this third rescue package addressed the immediate issue, but it did not implement an amenable long-term solution.<sup>54</sup>

The third smallest member of the Eurozone, the island nation Republic of Cyprus, became the fourth country that required a Eurozone bailout to avert a bankruptcy. A central causal factor of the country's crisis stemmed from the nation's banking system, which had invested heavily in Greek bonds and subsequently incurred enormous losses when the Greek's restructured their debt. The nation also experienced a deep recession in 2009 as a result of the global economic conditions and a drop in the country's vital tourism industry. This generated a rapid increase in unemployment that contributed to a corresponding increase in national debt.<sup>55</sup>

Through the 1990s, the Cypriot banking system grew disproportionately to the country's economic base, as a result of favorable banking practices and off-shore accounts. At the height of the economic boom, the nation's banking sector grew to eight times the size of the national economy. To increase investments the government created a financial sector that incorporated low tax rates and high deposit interest rates. As a result, the nation became the preferred location for the new Russian wealth that emerged

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<sup>54</sup> Whyman, *Political Economy of the European Social Model*, 289; Berend, *Europe in Crisis*, 31.

<sup>55</sup> Liz Alderman, "Question of Aiding Cyprus Places Germany in a Bind," *The New York Times*, February 3, 2013, [http://www.nytimes.com/2013/02/04/world/europe/cyprus-complicates-german-quest-to-save-euro-zone.html?\\_r=0](http://www.nytimes.com/2013/02/04/world/europe/cyprus-complicates-german-quest-to-save-euro-zone.html?_r=0); Peter Spiegel and Jamie Smyth, "Bailout Countries Given Seven Years' Grace," *Financial Times*, April 12, 2013, <http://www.ft.com/intl/cms/s/0/5d0d2834-a37a-11e2-8f9c-00144feabdc0.html#axzz2QDZYCx8h>.

out of Boris Yeltsin's economic reforms of the 1990s. This substantial influx of Russian deposits magnified the banking system's losses once the recession hit.<sup>56</sup>

In 2012, with the increasing pressures on the Cypriot government to shield state bank losses, the major credit rating agencies downgraded the nation's bond status to junk levels. As was seen with the previous nations that received this downgrade, this crucial decision caused interest rates on government bonds to rise to unsustainable levels, and created a now frequent occurrence where the penalized country eventually could not meet its repayment deadlines.<sup>57</sup>

In March 2013, the Eurozone and the IMF provided a €10 billion rescue package to the Mediterranean country of 800,000 people. In an effort to appease the rising discontent among Eurozone member nations towards repeated bailouts, the Cyprus package included bail-in provisions, in which bank customers would contribute a portion towards the overall rescue fund. As a result, the country was forced to close its second largest bank, the Laiki Bank, and transfer all assets to the nation's largest bank, the Bank of Cyprus. In addition, a tax was levied on uninsured bank accounts of balances above 100,000 euros with the intent to raise as much as €10 billion more for the rescue package. This bail-in provision may eventually encompass up to 60 percent of a balance on an account. Additional austerity measures were enacted, which included reducing public sector salaries by up to 15 percent, reducing state pensions by 10 percent, and implementing new property taxes. As resentment continues to grow towards the attached austerity measures, Cypriot parliament member George Perdikiis tersely surmised the wave of discontent spreading throughout the periphery states: "Its [Cyprus] democratically elected representatives have a gun to their head to agree to a deal of enslavement."<sup>58</sup>

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<sup>56</sup> Quentin Peel, "Germany Senses Unfairness Over Cyprus Plan," *Financial Times*, April 2, 2013, <http://www.ft.com/intl/cms/s/0/30b6f06c-9baf-11e2-a820-00144feabdc0.html#axzz2PtVBLRd2>.

<sup>57</sup> Harry Bradford, "Moody's Downgrades Cyprus Credit Rating to Junk on Greek Exposure," *The Huffington Post*, March 13, 2012, [http://www.huffingtonpost.com/2012/03/13/moodys-downgrades-cyprus-credit-rating-greek-exposure\\_n\\_1341230.html](http://www.huffingtonpost.com/2012/03/13/moodys-downgrades-cyprus-credit-rating-greek-exposure_n_1341230.html).

<sup>58</sup> Michele Kambas, "Cyprus Bailout Scrapes Through Island's Parliament," Reuters, April 30, 2013, <http://www.reuters.com/article/2013/04/30/us-cyprus-parliament-bailout-idUSBRE93S12M20130430>; Alderman, "Question of Aiding Cyprus Places Germany in a Bind."

The Italian and Spanish governments have not had to request a formal Eurozone bailout, but both member states have received alternate funding and have enacted strict austerity measures in response to the economic crisis. In Italy, the debate over cost saving measures led to the resignation of the once popular three-term Prime Minister, Silvio Berlusconi. The fresh Italian government was formed around the new prime minister and former economist, Mario Monti, who chose to continue harsh austerity measures. In December 2011, Monti enacted a \$40 billion austerity program that included reductions in pensions and increases in taxes. In an attempt to offset the austerity cuts, one month later the new prime minister introduced a \$7.1 billion infrastructure stimulus package. The results highlight the suppressive power of austerity measures on an economy. Two years after Monti took office, Italy continues to struggle as the cycle of recession has turned into a critical nationwide depression. The enduring austerity measures have drastically impacted small companies and households as bank lending has faded and borrowing costs, which have recently reached the 10 percent interest rate level, continue to rise.<sup>59</sup>

Spanish austerity measures have created continued hardship for the fourth largest Eurozone economy. As a result of the crisis, the People's Party decidedly defeated the incumbent Socialist Workers' Party in the November 2011 national election. The new Prime Minister, Mariano Rajoy, based his election campaign on the platform to turn the domestic economy around. Upon taking office, the new administration announced a €16.5 billion austerity program, which included over €6 billion in increased taxes, and promised to enact comprehensive labor reforms. The new government's efforts to turn around the economy have since been unsuccessful as the country's five year long recession continues. Spain currently has one out of every four citizens unemployed, the highest figure since the country transitioned to a democracy, and in the first time in

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<sup>59</sup> Wolfgang Münchau, "The ECB's Priority Should Be to Fix Southern Europe," *Financial Times*, April 7, 2013, <http://www.ft.com/intl/cms/s/0/df18590a-9d4b-11e2-a8db-00144feabdc0.html#axzz2QDZYCx8h>; Berend, *Europe in Crisis*, 34, 53.

recorded history, the nation has witnessed a reduction in population as construction sector workers return to their country of origin.<sup>60</sup>

## **B. RECOVERY AND RESCUE PACKAGES**

The five formal sovereign bailouts that took place between May 2010 and March 2013 only represent the highpoints of the intense negotiations and massive funds that were allocated throughout this timeframe, all in the continued attempt to stabilize the Eurozone. This period forced the financially stable member states to move to the forefront and provide funding to supplement the Union. In return for these outlays, the stronger “core” members required the “periphery” states that were in receipt of aid to enact harsh austerity measures. This requirement both helped and hurt the situation; it demonstrated to the citizens of the contributing nations that they are were not giving their money away for free, but at the same time, it forced drastic cuts in the receiving nations that has worked to suppress financial growth and economic recovery. This is the conundrum that continues to work against a Eurozone recovery.

Another issue with the early aid packages was the amount of the recovery funds, which only provided a piecemeal solution to a greater problem. Although hindsight accentuates this point, at the time comparisons could be made towards other global recovery initiatives. In 2008, at the height of the global economic crisis, all of the members of the EU, with the exception of Poland and Slovakia, were in a recession. Additionally, Estonia, Latvia, and Lithuania met the requirements of being in an economic depression. In December 2008, the European Council approved the European Economic Recovery Plan (EERP), an EU stimulus program of €200 billion, which equated to 1.5 percent of the EU-wide GDP. In contrast, the United States enacted the American Recovery and Reinvestment Act (ARRA), which provided a \$787 billion stimulus program that equated to nearly five percent of the U.S. GDP. This discrepancy

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<sup>60</sup> Ciaran Giles, “Luis De Guindos, Spain Economy Minister: Spain May Fall Back Into Recession,” *The Huffington Post*, December 26, 2011, [http://www.huffingtonpost.com/2011/12/26/luis-de-guindos-spain-economy-minister\\_n\\_1169960.html](http://www.huffingtonpost.com/2011/12/26/luis-de-guindos-spain-economy-minister_n_1169960.html); Fiona Ortiz, “Spain Population Shrinks Amid Economic Crisis, Soaring Unemployment,” Reuters, April 22, 2013, <http://worldnews.nbcnews.com/news/2013/04/22/17862313-spain-population-shrinks-amid-economic-crisis-soaring-unemployment?lite>; Berend, *Europe in Crisis*, 53.



created a dispute between the EU and a group that consisted of the U.S., the IMF, and the Organisation for Economic Co-Operation and Development (OECD). Indicative of the inherent weakness of the EU's supranational governance, the member states resisted calls for a greater unified response, and instead chose to allow members to take additional actions at the sovereign level. This crucial political decision, when the economic crisis was in its infancy, forced Eurozone members to attempt to combat the continuing crisis on their own. As a divided union, they failed.<sup>61</sup>

Throughout 2009, conditions continued to deteriorate in the Eurozone as member states were handcuffed in how they could respond. This limitation highlighted a shortcoming of Eurozone membership; the inability to devalue one's currency. As members joined the third stage of the EMU, they surrendered sovereign monetary policy to the ECB and submitted to the bank's controls and regulations. As conditions got worse for the GIIPS countries, the ECB was forced into the position of a middleman between the stronger and weaker members. As the stronger states were allocating the emergency funds, they gained the advantage in dictating policy, which included maintaining the status quo to inhibit the negative potentials of devaluation and controlling against the risk of inflation. As budget deficits continued to increase in the periphery states, the state leadership could not use currency depreciation to improve their international price competitiveness and promote export-led domestic growth that would have quickly reduced their deficits. Instead they were forced to change domestic policies, which included public sector cuts, pension reforms, wage reductions, and tax increases. These austerity measures countered any potential for growth and forced the continuation of economic hardships.<sup>62</sup>

In finalizing the Greek rescue package in May 2010, the Eurozone leadership realized that overall conditions were continuing to deteriorate and additional action was needed to stem the sovereign debt crisis. As such, two precarious years after the EERP was approved, the Eurozone created the European Financial Stability Facility (EFSF). The EFSF's mandate "is to safeguard financial stability in Europe by providing financial

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<sup>61</sup> Bermeo, *Coping with Crisis*, 91–92.

<sup>62</sup> Pugel, *International Economics*, 597–98; Bermeo, *Coping with Crisis*, 182.

assistance to euro area Member States within the framework of a macro-economic adjustment programme.”<sup>63</sup> To fund this program, the European Commission proposed the issuance of Eurobonds backed by a collective government guarantee of all Eurozone members. German leadership was staunchly opposed to this idea and instead forced the concept of lending based on bilateral loans. During the negotiation process, the EU’s legal representatives supported the German position, declaring that Eurobonds would require treaty changes. This decision began the continuing debate on the need for Eurobonds to stabilize the continuing Eurozone crisis.<sup>64</sup>

The EFSF was subsequently used to provide funding for the Irish, Portuguese, and second Greek rescue packages discussed above. The agreement created a temporary rescue mechanism that was authorized to borrow up to €440 billion by issuing domestic bonds or other debt instruments that were based on the solid credit ratings of the core members. In a move that demonstrated that Germany was emerging as the financial leader in the Eurozone, the country provided €119 billion, or 27 percent, to the overall fund. The second largest contributor, France, contributed €89 billion, or 20 percent, to the EFSF. Additionally, the IMF was permitted to contribute up to €250 billion in assistance. Once again, this program was generally received as a partial solution, similar to the EERP, as lengthy negotiations between the EU and the potential recipient of funds became a prerequisite before aid was provided. This created uncertainty in the bond market and inadvertently promoted volatile market speculation of a possible Eurozone break-up.<sup>65</sup>

In an effort to instill confidence in the financial markets, in October 2010, the Eurozone’s leadership finally decided that a permanent rescue mechanism was needed for the Union. To this end, the Eurozone introduced the European Stability Mechanism (ESM), which entered into force in October 2012. This program sanctioned the European Commission to raise €60 billion in bonds, using the EU’s budget as collateral, and

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<sup>63</sup> “About EFSF,” European Union, accessed May 8, 2013, <http://www.efsf.europa.eu/about/index.htm>.

<sup>64</sup> Bermeo, *Coping with Crisis*, 148.

<sup>65</sup> “About EFSF,” Bermeo, *Coping with Crisis*, 148–49.

directed the continued cooperation with the IMF. As finalized in the negotiations, this program was also not to be categorized as Eurobonds but as a means to provide assistance to safeguard the financial stability of the Eurozone. The ESM was soon called into action in December 2012, to allocate €39 billion to recapitalize the Spanish banking sector, and later in February 2013, to provide an additional €1.8 billion to the nation's banking industry.<sup>66</sup>

The EFSF and the ESM are scheduled to run concurrently through mid-2013, at which time the ESM will take over the primary role of providing all new financial assistance and the EFSF will only continue to manage its outstanding debts. As a further sign of the continuing support for the Eurozone and of the increasing political institution-building that is occurring within the Union, the ESM budget has been increased to €50 billion through member obligations. Once again, Germany has pledged to provide 27 percent of the capital for this permanent bailout fund.<sup>67</sup>

### **C. THE TROIKA**

The three members of the “Troika,” the European Commission, the International Monetary Fund (IMF), and the European Central Bank (ECB) have all played a crucial role in the Eurozone sovereign debt crisis. This label was created to symbolize the critical partnership that has formed between the three entities as they continue to combat the crisis through rescue packages and funding. Each entity has authorized and allocated substantial resources to the bailout funds that have been distributed to date. As this has occurred, the role of the ECB has noticeably evolved throughout this period to allow for an enhanced crisis response.<sup>68</sup>

The European Commission has used its right of initiative to propose the recovery packages that became the EFSF and the ESM. As these programs have increased in size, the commission has found itself controlling an unexpected and powerful European

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<sup>66</sup> Lynn, *Bust*, 178; “About ESM,” European Union, accessed May 8, 2013, <http://www.esm.europa.eu/about/index.htm>.

<sup>67</sup> “About ESM.”

<sup>68</sup> “The IMF and Europe,” International Monetary Fund, last modified April 9, 2013, <http://www.imf.org/external/np/exr/facts/europe.htm>.

monetary fund, which may be perceived as a rival to the IMF.<sup>69</sup> The organization consists of a representative from each EU member state, but when dealing with the Eurozone crisis, a member's share of the overall monetary contribution carries political weight. As such, Germany has considerable influence over this leg of the Troika with its 27 percent contribution to the rescue funds. This has allowed German officials to attach strict austerity measures to the bailout packages and to halt the commission's Eurobond initiative.<sup>70</sup>

The International Monetary Fund, created from the Bretton Woods Conference of 1944, was designed to assist in the challenges currently facing the Eurozone. As the IMF's objectives declare, "It provides policy advice and financing to members in economic difficulties."<sup>71</sup> The IMF has contributed over €77 billion to the Irish, Portuguese, Greek, and Cypriot rescue funds. As a result, in April 2012, numerous IMF member nations pledged to provide over \$430 billion in additional funding if the organization requires it for further Eurozone rescue programs.<sup>72</sup>

Member nations contribute money to the IMF's dispersal fund through a quota system. The member's size in the global economy defines its assigned quota, which in turn determines the country's voting power within the organization. The United States, having the largest global economy, contributes the most and has the highest voting share, set at 16.75 percent. Germany has the third largest member state economy, and as a result, has a 5.81 percent share of total votes. As there are 188 members of the IMF, the German delegation has a limited say in the conditions attached to the IMF funds used in the Eurozone sovereign debt crisis.<sup>73</sup>

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<sup>69</sup> Whyman, *The Political Economy of the European Social Model*, 284; Ousmène Mandeng, "The IMF Must Quit the Troika to Survive," *Financial Times*, April 17, 2013, <http://www.ft.com/intl/cms/s/0/a9e49a86-a6bb-11e2-885b-00144feabdc0.html#axzz2SIPSTnyf>.

<sup>70</sup> Kabir Chibber, "Who are the Troika that Greece Depends On?" *BBC World News*, October 4, 2011, <http://www.bbc.co.uk/news/business-15149626>.

<sup>71</sup> "Overview," International Monetary Fund, accessed May 8, 2013, <http://www.imf.org/external/about/overview.htm>.

<sup>72</sup> "IMF and Europe."

<sup>73</sup> "IMF Executive Directors and Voting Power," International Monetary Fund, last modified May 9, 2013, <http://www.imf.org/external/np/sec/memdir/members.aspx>.

The European Central Bank has undertaken a significant evolution since the start of the Eurozone crisis, as the organization has transformed from being a reluctant and proudly independent member to a more active participant of the Troika. Upon its inception in June 1998, the ECB was originally mandated to combat inflation. The TFEU clearly defines the purpose of the ECB: “The primary objective of the European System of Central Banks...shall be to maintain price stability.”<sup>74</sup> This anti-inflationary focus reveals the German influence over the ECB, as this ideal parallels that of the German central bank, the Bundesbank.<sup>75</sup>

In the opening years of the Eurozone crisis, the ECB deliberately left the EU response to the European Commission. This decision was in large part due to the TFEU directive that the ECB is not allowed to provide direct support to Eurozone governments. This changed in May 2010, when the ECB began to purchase Greek bonds in the effort to show support for the domestic bond market and in the attempt to bring interest rates down to a sustainable level. Since then, the ECB’s Securities Market Programme (SMP) has continued its bond purchasing program with the subsequent purchase of Irish, Portuguese, and Cypriot bonds. Additionally, the SMP has purchased Spanish and Italian bonds, which created an alternative rescue package for these two member states. At the end of 2012, the SMP portfolio included €43.7 billion in Spanish debt and €9 billion in Italian bonds.<sup>76</sup> As John Authers observes, a majority of EU politicians valued this program as it “was the easiest political way out, as the ECB had the power to print money—even if this risked inflation later on.”<sup>77</sup> This program, however, has created friction between the ECB and German officials, as Germany believes this action is outside the original mandate of the ECB and threatens possible inflation. In September

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<sup>74</sup> “Tasks,” European Central Bank, accessed May 9, 2013, <http://www.ecb.int/ecb/tasks/html/index.en.html>.

<sup>75</sup> Lynn, *Bust*, 24.

<sup>76</sup> Michael Steen, “ECB Unveils €1.1bn Profit on Crisis Bonds,” *Financial Times*, February 21, 2013. <http://www.ft.com/intl/cms/s/0/c9a5a882-7c32-11e2-bf52-00144feabdc0.html#axzz2La8J2kVX>.

<sup>77</sup> Authers, *Europe’s Financial Crisis*, 119.

2011, Germany's Juergen Stark, the ECB's chief economist, resigned over disagreements with this bond purchasing program.<sup>78</sup>

As the Eurozone sovereign debt crisis continues unabated, the ECB has intensified its discourse that it should become more involved in resolving the crisis. In July 2012, the ECB's President, Mario Draghi, firmly stated, "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."<sup>79</sup> In September 2012, Draghi followed through on his promise with the introduction of the ECB's Outright Monetary Transactions (OMT) program. The OMT was designed to replace the limited and unconditional restraints that were enacted on the SMP with a new unlimited and conditional program. The potential size of this new bond-buying program is unlimited but it also includes strict fiscal conditions for the receiving member state. Although no country has yet to apply for the OMT program, its availability is attributed to a reduction in Eurozone market interest rates. German leadership and the nation's media has publicly criticized the OMT initiative, regarding it as a program that would write a "blank check" to a country and one that is a potential source for inflation. This disapproval was formally acknowledged as Jens Weidmann, the Bundesbank president, became the only member of the ECB governing council to vote against the new program. This crowning incident reveals the evolution that the ECB has undergone since the start of the Eurozone crisis. Created in the image, and with the same objectives of the Bundesbank, German leadership has now openly criticized this once aligned EU institution.<sup>80</sup>

The Eurozone sovereign debt crisis has had a tremendous impact on the European Union. The once assumed unlimited growth and potential quickly turned into a tremendous hardship and expense. The periphery countries of Greece, Ireland, Portugal, and Cyprus soon found that they did not have the money to sustain their nations. This resulted in huge monetary rescue packages that also carried with them strict fiscal

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<sup>78</sup> Chibber, "Who are the Troika that Greece Depends On?"

<sup>79</sup> Lionel Barber and Michael Steen, "FT Person of the Year: Mario Draghi," *Financial Times*, December 13, 2012. <http://www.ft.com/intl/cms/s/0/8fca75b8-4535-11e2-838f-00144feabdc0.html>.

<sup>80</sup> Barber, "FT Person of the Year: Mario Draghi."

policies of austerity and structural reforms. The economic downturn has also dramatically impacted Italy and Spain, who have undertaken harsh reforms that have caused a dramatic rise in unemployment levels.

The financial crisis forced the Eurozone member states and their affiliates to join together in an attempt to find a solution for the problem. In doing this, the EU enacted the European Economic Recovery Plan, the European Financial Stability Facility, and the European Stability Mechanism. All have successively increased the Eurozone members' monetary commitments and time guarantees towards resolving the crisis.

Lastly, the Eurozone crisis has caused the three members of the Troika, the European Commission, the International Monetary Fund, and the European Central Bank, to join together in the effort to fight the economic disaster. The European Commission and the IMF quickly began to work together to create the sovereign rescue packages, while the ECB reluctantly transformed from a passive to an active member of the team. In doing this, the ECB has progressed from sponsoring the Securities Market Programme to the Outright Monetary Transaction program, all in the effort to quell the uncertainty in the European financial markets.

As the Eurozone's response has progressed, a distinction has arisen between the members who are financially capable of supporting the rescue measures and those who will continue to need support. As such, Germany has arisen to take the leadership role with its continuing financial commitment to the EU. The tumultuous history of the nation state and the perceived necessity for a long-lasting EU are both significant factors for this crucial Eurozone member state.

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#### IV. THE ROLE OF GERMANY IN CRISIS

The Federal Republic of Germany has recently emerged as the pivotal member of the Eurozone sovereign debt crisis. The country has provided substantial funds to the European Union, all in an effort to keep the Eurozone intact and the euro currency afloat, but also because such a goal is in the German national interest. The trials and tribulations of the twentieth century help to present an understanding of this new role, which has been long in the making and in some sense signifies a return of Germany's central role in the European political economy of the past. The German social market economy that emerged in the postwar era enabled West Germany to overcome the devastation it had endured in the first half of the century, while it provided the foundation for the pursuit of the domestic and international goals of economic growth, employment, and price stability. At the conclusion of the Cold War, the successful reunification of the German state enabled the country to continue with its export-oriented industrial growth. The country would eventually emerge as the top European exporter and would only trail China in the overall global export market.

A combination of tradition, thrift, good fortune, U.S. largesse, and an emphasis on manufactures, as well as social peace through what is more or less an egalitarian culture of the German population, have all contributed to the country's economic success. The Prussian, Schwabian, and otherwise traditions combined with the legacy of debt in the epoch of total war have reinforced the virtues of thrift, combined with what is also a deep skepticism of speculation in capitalism and a downright anti-money attitude among some in the middle class and surely within the working class. The importance of this characteristic may be appreciated in the translation of the German word *Schuld*, which means both debt and guilt.<sup>81</sup> Such moralization in the matter of fortune and economy also ensued through the burdens worked by the unification of Germany, with its huge load of transfer payments and debt in the rebuilding of the ex-GDR, an investment whose

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<sup>81</sup> Robert Kuttner, *Debtors' Prison: The Politics of Austerity versus Possibility* (New York: Alfred A. Knopf, 2013), 175.

wisdom showed itself assuredly in the wake of the 2007–2008 crisis. One also looked mistrustfully, though often without good reason, at what was deemed rightly or wrongly to be the spendthrift habits of southern Europeans, especially Greeks, with whom the Germans have a long and rich bond of love and hate through the centuries.<sup>82</sup>

Beginning in the 1970s, the West German government embarked itself on deficit spending and counter-cyclical measures in the face of the world economic challenges of the oil embargo years and stagflation. In the recent past, though, the government of the Federal Republic of Germany has revived the customs of thrift for as much domestic political reasons as those of the European political economy. Within the European Community and then European Union, the Germans had paid into the pot, while others had extracted benefits, similar to the circumstances within the FRG and the rich southern states (i.e., Baden-Wuerttemberg and Bavaria), which had made tax contributions to the northern states that were less prosperous. This process was then amplified after unification in 1990 and led to a current of discontent, especially within the rank and file of German voters who have silently borne this burden sharing over the past two decades.

This German school of economic beliefs has created friction within the Eurozone as Germans expect fellow member states who receive their aid to now enact strict austerity measures and structural reforms, while those receiving German funds believe this request is too demanding. As the German nation state continues to assume more political and economic responsibilities within the Eurozone, this disagreement will only become greater with time.

This chapter will discuss the unique German experiences of the twentieth century that facilitated the beliefs and principles of the individual German citizen, and which formed the nation's political response to the Eurozone crisis. This influential era, and the institutions that arose out of the 1950s, will be discussed. This will be followed with insight into the importance of German monetary stability and the posturing of German

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<sup>82</sup> Maria Lorca-Susino, *The Euro in the 21st Century: Economic Crisis and Financial Upheaval* (Burlington, VT: Ashgate Publishing Company, 2010), 190; Lynn, *Bust*, 6, 11.

industry towards an export-focused economy. The successful German reunification will be addressed, as will the evolving role of the German nation state in the current financial crisis.

#### **A. THE GERMAN NATION STATE OF THE 20TH CENTURY**

The economic trials of the Weimar Republic (1919–1933) and the tyranny of the Third Reich (1933–1945) profoundly contributed to the character of the post-World War II West and East German economies, with the latter collapsing itself with the end of the Soviet system within Europe in 1990. Having experienced the tumultuous era of economic calamity and totalitarianism, the two Germanies that emerged from the ruins of the Second World War were determined not to repeat the mistakes of the first half of the century. In this effort, West German leadership developed an innovative economic system for the country, which became recognized as a social market economy, a more or less evolution from the economic system of the nineteenth century through the Third Reich. This system incorporated a free market structure using some state controls, with a social dimension that was created to protect the rights of the worker as had more or less been the case in earlier periods as well, and which generated a bulwark against socialism in the GDR and the Soviet Union. In addition, to counter the possibility of a new round of hyperinflation, German economics expert under the occupation, Dr. Ludwig Erhard, launched a currency reform program with the allies in June 1948 that introduced a new stabilizing currency, the Deutsche Mark, which presently became the foundation of the FRG. As Patrick Boarman stated in 1964 of the successes of the new West German economic system, “Freedom in the realm of goods, discipline in the realm of money—these were the twin pillars of a grandiose economic conception which ... lifted Germany from the almost total desolation of the years 1945–48 to a level of sustained economic performance in the succeeding decade which was unmatched in the Western world.”<sup>83</sup> The adaptation and successful implementation of the West German social market economy, at a time of the advance in the Korean War and the transatlantic pact, created a competitive and vibrant economic system, but just as importantly implemented a social

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<sup>83</sup> Boarman, *Germany's Economic Dilemma*, 21.

partnership between industry and labor that was able to regulate the rise in wages as the economy matured. Half a century later, the German social market economy, functioning in the wake of Chancellor Gerhard Schröder's reforms, gave the country an advantage over its neighbors, as wages became an unsustainable drain on Eurozone periphery member state economies.<sup>84</sup>

The West German social market economic expansion of the 1950s allowed the country to rapidly recover from its postwar devastation. Between 1950 and 1955, the country experienced a nine percent annual increase in its gross national product (GNP). From 1955 to 1959, GNP grew at an average rate of 5.2 percent annually. This growth rate was the highest in the European community and even surpassed that of the United States. As a result, West Germany was able to combat the high unemployment rate of the postwar period and successfully to incorporate over 10 million incoming refugees from the Communist-controlled regions to the East. As an indicator of success, the unemployment rate went from 10.3 percent at the start of the 1950s, down to 0.7 percent in 1962, and over six million new residential units were constructed for the growing population during this same period.<sup>85</sup>

The achievements of the post-World War II era produced a tremendous benefit for the West German state and for Western Europe in the Common Market and the EC; it instilled a renewed sense of public confidence that hard work, skill, and monetary discipline would lead to prosperity and economic opportunities. In addition, the success of the era strengthened the confidence of the populace towards government institutions, such as that of the Bundesbank and the stability of the Deutsche Mark. This, in turn, promoted a rise in personal savings that infused money into the economy. The 1950s also gave West Germans the opportunity to move beyond the traumatic memory of the 1920–23 period of hyperinflation, which contributed to the political events of the next

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<sup>84</sup> Lorca-Susino, *Euro in the 21st Century*, 190–91; Boarman, *Germany's Economic Dilemma*, 21–22.

<sup>85</sup> Boarman, *Germany's Economic Dilemma*, 23–24.

decade, and the stifling period of economic inflation that accompanied World War II. With this new confidence, and a continued respect for the past, the German recovery pressed forward.<sup>86</sup>

Twenty years after the West German nation state started down the road of economic recovery, monetary policy was still at the forefront of concern for German citizens. This economic fixation evolved into the political realm, where “the interconnections of finance and politics have become especially visible.”<sup>87</sup> The advancements in the postwar period reinforced the benefits of sound economic policy, and in doing so, created a sovereign determination towards the goals of economic growth, employment, and price stability. At a time when the first economic recession had darkened the prospects of the young FRG in the late 1960s, West German Chancellor Willy Brandt proclaimed in 1970, “This Administration is also aware that we can only assure social and political stability in a growing economy.”<sup>88</sup> To sustain this economic growth, and its by-product of low unemployment, the West German government and the Bundesbank placed an emphasis on nurturing an export-based economy as the key to continued stability. Of even greater concern than these first two goals was the pursuit of price stability within the economy. In a 1970 poll, 76 percent of the West German population preferred price stability to economic growth.<sup>89</sup>

This followed the strong anti-inflationary conviction that stable prices lead to social order within the nation state, and this order is necessary to prevent a reoccurrence of the events of the early twentieth century. In essence, these goals became a German cultural identity in the continual effort to maintain an overall social-political-economic

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<sup>86</sup> Wadbrook, *West German Balance-of-Payments Policy*, 62; Boarman, *Germany's Economic Dilemma*, 22, 29–30.

<sup>87</sup> Wadbrook, *West German Balance-of-Payments Policy*, 54.

<sup>88</sup> *Ibid.*, 55.

<sup>89</sup> *Ibid.*, 62.

order.<sup>90</sup> These post-World War II economic goals continue to be an essential influence in the German response to the Eurozone sovereign debt crisis.<sup>91</sup>

The striking reverent status that the West German populace bestowed upon the Bundesbank and its currency, the Deutsche Mark, highlighted the importance that was placed on sound economic policy. Unlike other federal banks, the Bundesbank is seen as a guardian for all that Germany represents. As Matthew Lynn proclaims, “It is more like a flag or an anthem or an ideal than a bank: something to be respected, defended, even sometimes to be fought for.”<sup>92</sup> The Bundesbank, which was only established in 1957, ultimately and firmly corrected the problems of its predecessors—the Reichsbank and the Bank Deutscher Länder. The Reichsbank was created in 1876 to coordinate the monetary policy of the new German nation state. This bank soon fell under the control of the federal government in the period before World War I and once again when the Fascist regime gained power. The Reichsbank was responsible for poor monetary policy that contributed to the inflationary periods of the two World Wars and the hyperinflation of the 1920s. To put the actual hardship German citizens had to endure into perspective, from July 1923 to November 1923 prices of German domestic goods increased by 850 billion percent, and the exchange rate between the U.S. dollar and the German mark was set at 4.2 trillion marks to one dollar.<sup>93</sup> The bank added to the financial chaos by introducing three different currencies during its tenure: the papermark, the rentenmark, and the reichsmark. In 1948, the occupying powers of West Germany established the Bank Deutscher Länder in an attempt to improve the postwar economic conditions. The greatest achievement of this bank was the introduction of the new currency, the Deutsche Mark. This provisional government bank soon yielded to the domestic pressures for a German conceived national bank that would represent the ideals and convictions of the German nation. This new institution became known as the Bundesbank.<sup>94</sup>

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<sup>90</sup> Ibid., 67–68.

<sup>91</sup> Lorca-Susino, *Euro in the 21st Century*, 191; Wadbrook, *West German Balance-of-Payments Policy*, 54–62.

<sup>92</sup> Lynn, *Bust*, 78.

<sup>93</sup> Sobel, *International Political Economy in Context*, 388.

<sup>94</sup> Lynn, *Bust*, 78–80.

The immediate success of the Deutsche Mark in post-World War II Germany introduced an era of monetary stability for the war-weary population. The currency soon became a symbol of strength and one of national pride for the German people. As the nation's economy evolved into an export-biased system, the Deutsche Mark held its value against the global domination of the U.S. dollar. In contrast to the other leading European nations, including Britain, France, and Italy, which had to devalue their currencies against the dollar, the Deutsche Mark increased in value against the global currency. Throughout the recession and inflationary periods from 1960 to 1998, the Deutsche Mark retained 30 percent of its original value. In contrast, the U.S. dollar preserved 20 percent of its value, the French franc 13 percent, and the British pound only 8.5 percent. Understandably, as discussion began on the new EU monetary union, the German faction insisted that the new euro should be "a worthy successor to the indomitable deutschmark, the rock on which Germany's postwar reconstruction had been built."<sup>95</sup> The enduring confidence of the Deutsche Mark throughout the second half of the twentieth century demonstrated that the currency had become the foundation for the successful German economy.<sup>96</sup>

As financial success facilitated the rebuilding of the West German nation, and later a united country, the memory of the atrocities that accompanied World War II lingered in the minds of the German people. In a similar belief that a strong German national bank and currency were essential to preventing a third world war within one century, citizens believed that integrating their country into the greater European community was critical to an enduring peace. Jürgen Habermas, a prominent German philosopher, acutely stated this German mentality: "Within the constellation following the Second World War, the cautious pursuit of European unification was in the country's interests because it wanted to return to the fold of civilised nations in the wake of the Holocaust."<sup>97</sup> In effect, the memory of World War II bestowed upon the German people

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<sup>95</sup> Ibid., 34.

<sup>96</sup> Lorca-Susino, *Euro in the 21st Century*, 191–92; Lynn, *Bust*, 82–83.

<sup>97</sup> Stuart Jeffries, "A Rare Interview with Jürgen Habermas," *Financial Times*, April 30, 2010, <http://www.ft.com/intl/cms/s/0/eda3bcd8-5327-11df-813e-00144feab49a.html#axzz2TalRtLoZ>.

a sense of shame of what the nation had engaged in, and in doing so, forced a suppression of nationalism in order to promote the greater European good. This mindset legitimized the acceptance of a new monetary union that was not entirely in the best interest of the German nation state.<sup>98</sup>

Another significant event that contributed to the German support for the Eurozone was the reunification of the German nation at the end of the Cold War. As the prospect of reunification arose after the fall of the Berlin Wall in 1989, many European nations were opposed to the idea out of concern that a reunited German state would once again become the dominant power in the region. Leading the opposition was British Prime Minister Margaret Thatcher and French President François Mitterrand who voiced their concern over the idea in the latter part of 1989 and the early part of 1990. In the end, Prime Minister Thatcher acquiesced to the plan after it was agreed that NATO could hold maneuvers in the former East German region, and President Mitterrand consented once German Chancellor Helmut Kohl agreed to join the EMU, which included the future third stage of the euro. As East and West Germany reunited, “The country had bought into the single currency, in part as a quid pro quo for the rest of Europe accepting the reunification of Germany without any protest.”<sup>99</sup> With the ostensible agreement of the nation’s leadership and the citizens of the country, Germany proceeded forward with the implementation of the euro.<sup>100</sup>

The negotiations for the creation of the euro program underscore the diversity inherent within the EU, as a debate soon arose concerning what type of euro would be created. The German faction supported an anti-inflationary currency, based on the German Deutsche Mark, and a new central bank that would promote independent monetary policies similar to the Bundesbank. The French contingent-led opposing bloc promoted a currency and central bank that was more conducive to political control, similar to the Bank of France. The subsequent negotiations resulted in a compromise, which became the limits and controls detailed in the Stability and Growth Pact. In

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<sup>98</sup> Lynn, *Bust*, 86–88.

<sup>99</sup> *Ibid.*, 28.

<sup>100</sup> Van Overtveldt, *End of the Euro*, 4; Lynn, *Bust*, 90–91.



addition, the TFEU modeled the new ECB on the Bundesbank and included the declaration that it was illegal for member governments to attempt to influence bank policy. Given these results, the Germans had a large political influence on the foundation of the new currency and on the bank that would control the Eurozone economy.<sup>101</sup>

In the last year of the twentieth century, European integration took a large step forward, but unique sovereign core values persisted. As was detailed above, many periphery member states continued their hazardous monetary policies that eventually became unsustainable. In contrast, German citizens held firm to their financial beliefs that had produced the successes of the second half of the century. As public and private debt skyrocketed around the globe and credit became the new purchasing standard, German citizens held to their principles of saving money, living within their means, and controlling the rise of wages. This mentality is demonstrated by the statistic that the 82 million citizens of Germany own 93 million debit cards, but only carry 20 million credit cards. In contrast, the 300 million residents of the United States possess 1.5 billion credit cards.<sup>102</sup> In addition, the business sector remained focused on cultivating its high-quality export-based industry and creating innovations to improve productivity. This approach has allowed the country to become the leading manufacturer of automobiles within Europe, as it now produces nearly three times as many vehicles as its next competitor, France, and has created Europe's favorite automobile brand, the German Volkswagen.<sup>103</sup>

In the first decade of the new century, Germany became the second-largest exporter in the world, trailing only behind the massive low-end product export market of China. The country experienced a rise in exports from 21 percent of GDP in 1970 to 47 percent in 2008.<sup>104</sup> In terms of productivity, the OECD calculated that Germans produced \$55.30 in GDP for each hour they worked, which could be compared to the

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<sup>101</sup> Lynn, *Bust*, 24–29.

<sup>102</sup> Berend, *Europe in Crisis*, 109.

<sup>103</sup> Dominic Sandbrook, "How German Cars Beat British Motors—and Kept Going," *BBC News Magazine*, August 1, 2013, <http://www.bbc.co.uk/news/magazine-23406467>.

<sup>104</sup> Carlo Bastasin, "Germany: A Global Miracle and a European Challenge" (working paper, Brookings Global Economy and Development, Washington, DC, 2013), 13.

periphery states of Greece and Portugal whose citizens produced \$33.90 and \$32.50 in GDP per hour during this period.<sup>105</sup>

The success of the export-focused German economy progressively created a divergence in the balance sheets of the Eurozone member states. This dynamic was reinforced by the increased demand for German goods throughout Europe. As a result, the German economy experienced repeated trade surpluses, while the periphery Eurozone member states accumulated massive trade deficits throughout the 2000s. This trend caused a financial unbalancing of the Eurozone, as Germany and the group of core member states maintained controlled growth and low inflation, while the periphery member states experienced fast growth and high inflation. The financial crisis that began across the Atlantic created the spark that ignited the tinder under the precarious European system.<sup>106</sup>

## **B. GERMANY'S UNEXPECTED POWER IN THE 21ST CENTURY**

The opening decade of the twenty-first century witnessed a transformation in the German nation state. The ideas and beliefs that accompanied the recollection of the nation's violent past gradually gave way to a new generation whose personal experiences were formed more from the successful reunification of the country than from the country's destructive past. As was occurring around the world, the members of the "greatest generation" were giving way to one that did not suffer through total war.<sup>107</sup>

In Germany, the conciliatory political policy agenda gradually yielded to a more equitable and dynamic mindset. After more than half a century, German citizens and the nation's political leadership believed their country could once again promote a sense of nationalism on the European stage. A defining moment in this evolution was the 2006 FIFA World Cup soccer event that was held in Germany. With a worldwide audience of over 30 billion people, Germans throughout the unified country exhibited their

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<sup>105</sup> Lynn, *Bust*, 88–90.

<sup>106</sup> Authers, *Europe's Financial Crisis*, 20–21.

<sup>107</sup> Lynn, *Bust*, 88.

nationalistic spirit by flying the country's flag in support of the German team's run for the World Cup. The team finished in third place out of 32 contestants.<sup>108</sup>

German Chancellor Angela Merkel conformed to this new persona in her rise to lead the German nation state in 2005. The chancellor was born after World War II and was subsequently raised in East Germany. She lived through the Cold War and experienced the success of German reunification, beginning her political life during the integration of the two states. Merkel's political position allowed her to observe the positive effects of the German conservative economic path that preceded the Eurozone crisis. As such, her response to the economic calamity has held firm to the German principles that made the country the leader in the EU. These beliefs have validated the ultimatum that requires strict austerity measures and domestic structural reforms before Germany would consent to extending rescue funds to insolvent Eurozone member states. In addition, these funds would only be provided at the last moment, in an effort to demonstrate to the beneficiary, and the entire European Union, that this was not easy money. As political economist Waltraud Schelkle notes, Merkel's "stubbornness was counterproductive for the European Union but indicates the tenacity of a politician holding on to an idea of limited state involvement."<sup>109</sup> Unwittingly, as sovereign core values do not change easily, this requirement created an influx of anti-German political demonstrations within those recipient countries that follow a more liberalized economic approach.<sup>110</sup>

The thrifty mindset of the German population parallels that of their chancellor in believing that their hard earned money should not go easily to those counties who have not earned it. The overall support for requiring structural reforms in recipient member states, in large part, originates from Germany's own structural reforms that it had to endure in the early 2000s. In an effort to reduce the country's budget deficit, which in 2003 had violated the limits enacted in the Stability and Growth Pact, Germany enacted

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<sup>108</sup> "Italy Conquer the World as Germany Wins Friends," FIFA, accessed July 20, 2013, <http://www.fifa.com/worldcup/archive/germany2006/overview.html>; Lynn, *Bust*, 88.

<sup>109</sup> Bermeo, *Coping with Crisis*, 154–55.

<sup>110</sup> Lynn, *Bust*, 88–89.

comprehensive pension, unemployment, social benefits, and wage reforms. Unemployment entitlements were cut from a maximum of 36 months down to 12 months, and a provision was added that a recipient had to accept any lawful job the labor agency offered them. In addition, the federal retirement age was raised from 65 to 67 years. To fight unemployment and subdue inflation, real wages for German workers were suppressed, and subsequently, are still near the same level that they were in 1999.<sup>111</sup> As German citizens had to tolerate their own effective austerity measures it was only natural that they mandated this requirement upon those who received German money.<sup>112</sup>

As the Eurozone sovereign debt crises expanded, Germany became the member state who was paying the majority of the EU's bills. This has created a malevolent cycle of protest within the Eurozone; periphery member states who receive monetary aid with strict conditions continue to protest against the austerity measures, while German citizens protest against the ostensibly ungrateful recipients who are receiving their hard earned money. This struggle will continue as long as individual rescue packages continue to be distributed to member states, and is projected to gain political prominence with the upcoming fall 2013 German general elections. This unintended consequence of the Eurozone bailout packages has worked to interject a renationalization of policy-making within individual member states that has driven a wedge into the original intent of greater European unification.<sup>113</sup>

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<sup>111</sup> Marcel Fratzscher, "Scapegoating Germany is Easy but Wrong," *Financial Times*, April 10, 2013, <http://www.ft.com/intl/cms/s/0/793550b8-a13b-11e2-990c-00144feabdc0.html#axzz2QDZYCx8h>.

<sup>112</sup> Bastasin, "Germany: A Global Miracle and a European Challenge," 29–32.

<sup>113</sup> Lynn, *Bust*, 90–92; Fratzscher, "Scapegoating Germany is Easy but Wrong."

## V. OPTIONS FOR THE FUTURE

The Eurozone sovereign debt crisis has exposed a fundamental political and economic flaw within the European Union: The economic realities inherent within the diversity of the 17 member organization have damaged the political aspirations of the continent's elites. The decision now is what can and should be done in response to the crisis. German leadership and the Troika powers have firmly committed to doing whatever is necessary to combat the economic disaster.<sup>114</sup> While this rhetoric continues, citizens of the EU member states gradually intensify their disapproval towards the Eurozone state of affairs. Opposition movements and nationalist political agendas are gaining strength throughout the Eurozone, as shown with the rise of the neo-fascist Golden Dawn political organization in Greece's June 2012 national election, and the results from the February 2013 Italian general elections, where support for multiple political factions resulted in a hung parliament and no overall clear winner.<sup>115</sup> Additionally, residents of these economically depressed nations are venting their frustration through an increase in public protests against those holding the Eurozone purse-strings. This has brought a dramatic increase in anti-EU and anti-German demonstrations that directly reference repressive World War II conditions. As austerity measures continue to suppress national economies and unemployment gradually rises, this grass-roots opposition will steadily make it more difficult to implement a coalition-sponsored political resolution. As such, timely decisive action is critical to the future of the Eurozone.

The Eurozone is at a proverbial crossroads, which brings with it tough decisions that will affect the future of the global economy. In essence, the members have three options: they may continue to "muddle through" the sovereign debt crisis, they may enact substantial reforms, or they may choose to splinter and break-up the Union. Each choice will have a considerable short-term and long-term impact on Eurozone member

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<sup>114</sup> Blackstone, "Germany, France Back Pledge to Save Euro."

<sup>115</sup> Liz Alderman, "Right-Wing Extremists' Popularity Rising Rapidly in Greece," *The New York Times*, September 30, 2012, [http://www.nytimes.com/2012/10/01/world/europe/amid-greeces-worries-the-rise-of-right-wing-extremists.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2012/10/01/world/europe/amid-greeces-worries-the-rise-of-right-wing-extremists.html?pagewanted=all&_r=0).

states and the global financial markets. The first option is the course that the Eurozone political leadership has decided to undertake. This decision has provided a patchwork of temporary monetary solutions, but has not created a decisive and enduring response that is needed to quell apprehensive investors and repair domestic finances. The second option consists of substantial political reforms that focus on strengthening the supranational characteristic of the Eurozone and enacting a mutualization of sovereign debt in the form of Eurobonds. Many member states are open to this possibility, save for the one that holds the greatest economic influence, Germany. The third option introduces a variety of profound scenarios that would upset the very essence of the Eurozone. This choice may result in one, or possibly multiple Eurozone member states reverting back to their national currencies. It may also witness the creation of separate EU monetary zones, such as a North “core country” union and a South “periphery country” union, each with its own currency.<sup>116</sup>

This chapter discusses the options that are available to the Eurozone community to combat the ongoing sovereign debt crisis. The three options that are available to the monetary union each have substantial benefits and drawbacks. In addition, an examination focusing on Germany will be conducted to evaluate if this nation state should stay in or exit the Eurozone. As this chapter progresses, the candid prediction of German Chancellor Angela Merkel must remain at the forefront of thought: “The euro is in danger. If the euro fails, then Europe fails. If we succeed, Europe will be stronger. It is a question of survival.”<sup>117</sup>

#### **A. THE THREE ALTERNATIVES**

The current path that has been chosen for the Eurozone sovereign debt crisis is a result of political and economic compromise that has yielded short-term financial assistance and various rescue facilities, but has also created adverse domestic burdens

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<sup>116</sup> Rebecca M. Nelson, Paul Belkin, Derek E. Mix, and Martin A. Weiss, “The Eurozone Crisis: Overview and Issues for Congress,” Congressional Research Service, March 25, 2013, 9, <http://fpc.state.gov/c20412.htm>; Vivien A. Schmidt, “Can the EU Bicycle Turn Into a Jet Plan by 2020? Two Pathways for Europe,” The German Marshall Fund of the United States (September 2012): 2–3.

<sup>117</sup> Lynn, *Bust*, 237; Van Overtveldt, *End of the Euro*, 8.

and does not provide for a concrete long-term solution. The five government and one banking rescue package to date have committed over half a trillion euros to periphery member states.<sup>118</sup> These funds were successful in covering bond commitments and immediate expenses but did nothing to combat trade imbalances or increase domestic economic growth. In reality, the German-led austerity requirements attached to the assistance packages have stifled fiscal growth and promoted recessionary conditions within these fragile countries. This has created the possibility that additional rescue packages will be needed in the future.<sup>119</sup>

The current course of action has also included the before mentioned ECB outright monetary transactions program and discussion of creating a more encompassing Eurozone banking union with new budgetary rules. The OMT program has been credited with increasing market confidence but distressed members may be reluctant to utilize the program as it also demands strict austerity measures. Any discussion on banking reforms is positive, but once again, decisive action will produce greater results than drawn-out political deliberations.<sup>120</sup>

The second choice, to enact Eurozone structural reforms, is the most politically challenging option, but carries the greatest potential for long-term stability. Successful implementation will also create a stronger and more integrated Eurozone that will be properly positioned to represent the interests of the European Union on the global economic market. As such, this option presents the ways and means of fulfilling the aspirations towards a heightened level of European integration first introduced over sixty years ago.<sup>121</sup>

The fundamental barrier that must be overcome to enact this solution is the reluctance to surrender certain sovereign rights of the nation to a supranational entity. These include transferring state powers to the European Union institutions, notably the

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<sup>118</sup> Nelson, "Eurozone Crisis: Overview and Issues for Congress," 18.

<sup>119</sup> Schoenbaum, *Age of Austerity*, 11, 44; Nelson, "Eurozone Crisis: Overview and Issues for Congress," 9.

<sup>120</sup> Nelson, "Eurozone Crisis: Overview and Issues for Congress," 7–8.

<sup>121</sup> Schoenbaum, *Age of Austerity*, 44; Nelson, "Eurozone Crisis: Overview and Issues for Congress," 9.

European Commission and the European Parliament, and shifting banking controls to the European Central Bank. Additionally, the ECB should be given the authority to purchase government bonds directly, which would enable it to act as a lender of last resort. Once this is done, these organizations would take a proactive role in managing national budgets and overseeing state banking institutions. Implementation of this course of action would require the unanimous support of Eurozone member state leadership and the necessity to form a public campaign in support of reform. Member states would then need to incorporate the new arrangements and rules into their federal constitutions, and existing treaties would need to be updated, making this a permanent transformation. This will present a significant challenge, considering the current state of conditions within the Eurozone and the reluctance of German leadership, but one that is similar to overcoming the opposition of retiring 17 national currencies.<sup>122</sup>

The second part of these reforms must address the persistent outstanding balance of periphery member state debt, as this monetary anchor will prevent the EU economy from moving forward. A decisive act that would stabilize this element is to collectivize the outstanding Eurozone sovereign debt through the issuance of Eurobonds. This program would allow debtor member states to convert their existing government debt into a Eurozone level debt security. Doing this would remove the possible risk that a weaker member state may default on their outstanding commitments, as all member states now share the responsibility of the debt. This would immediately eliminate the persistent uncertainty factor that is present in the periphery member state's bond markets and thus would remove the counterproductive risk premiums attached to these bonds. As the stability of Eurobonds would likely be comparable to U.S. Treasury bonds, the periphery states would see a dramatic cost reduction in servicing this debt that would have lower yields and lower interest rates. Governments could then use these savings to apply fiscal stimulus measures that are essential for economic growth. This would release the periphery member states from the continuous repressive cycle inherent with austerity measures and high debt servicing levels. As growth ensues, the Eurozone's leadership

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<sup>122</sup> Nelson, "Eurozone Crisis: Overview and Issues for Congress," 9–10; Berend, *Europe in Crisis*, 129, 135.



could then turn its focus to implementing structural reforms to increase the market competitiveness of the periphery states, which would further improve the overall condition of the European Union.<sup>123</sup>

The German Council of Economic Experts, an official government advisory group, proposed an alternative to this comprehensive measure, with a program entitled the European Redemption Pact (ERP). Instead of incorporating the entire sovereign debt into the Eurobond program, the ERP proposes allocating public debt levels above the 60 percent threshold, referenced in the Stability and Growth Pact, to a common redemption bond fund. In essence, this proposal offers a compromise in burden sharing as it forces member states to continue to be directly responsible for 60 percent of their sovereign debt, while it allows members to transfer debilitating excessive debt to a higher responsibility.<sup>124</sup>

Unlike the unlimited Eurobond program, the ERP is designed to eliminate the comprehensive debt above the 60 percent SGP level for all participants within 20 to 25 years. In this regard, a member such as Greece that has a debt ratio in excess of 160 percent of GDP would have higher payment obligations compared to Spain, whose debt ratio is near 70 percent. In addition, as countries enact this long-term payment plan, they also carry the burden of not going over the 60 percent threshold again in the future. The ERP addresses this issue with various proposals for a roll-in phase, creating nationally mandated debt brakes, and with a plan of how payments are calculated.<sup>125</sup>

The ERP proposal incorporates the hazard of continuing restrictive economic pressures on weaker member states and on calculating the program's success based on expectations about the future. As is stated in the conclusion of the working paper, this

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<sup>123</sup> Schoenbaum, *Age of Austerity*, 46; George Soros, "How to Save the EU from the Euro Crisis," *The Guardian*, April 9, 2013, <http://www.guardian.co.uk/business/2013/apr/09/george-soros-save-eu-from-euro-crisis-speech>.

<sup>124</sup> Hasan Doluca et al., "The European Redemption Pact: An Illustrative Guide" (working paper, German Council of Economic Experts, Wiesbaden, Germany, 2012), 1, <http://www.sachverstaendigenrat-wirtschaft.de/schuldentilgungspakt.html?&L=1>.

<sup>125</sup> Peter Coy, "Germany Seeks Financial 'Redemption' for Europe," *Bloomberg Businessweek*, May 28, 2012, <http://www.businessweek.com/articles/2012-05-28/germany-seeks-financial-redemption-for-europe>; Doluca, "European Redemption Pact: An Illustrative Guide," 4.

plan is “based on a set of assumptions about future growth rates and interest rates of bonds issued by sovereigns and under joint and several liability.”<sup>126</sup> The long-term requirement of this program creates the potential for unforeseen economic conditions that may threaten the success of the European Redemption Pact decades down the road.<sup>127</sup>

The third option for combatting the current sovereign debt crisis is for the Eurozone to cease in its current form. The first prospect is for one or more current member states to surrender the euro and revert back to their previous national currency. In this scenario, either a stronger core country could exit or a weaker periphery state could depart. The greatest benefit of this option would be for a periphery member state to exit the Eurozone and then enact a sovereign currency deprecation program to promote export-led economic growth. If a core country withdrew, it would no longer be responsible for providing credit to the weaker member states and it would once again have the control to determine national monetary policy.<sup>128</sup>

The second prospect is for the Eurozone to splinter into a core country union and a periphery country union, each with its own currency. This alternative would reduce the economic diversity that is inherent in the 17 member organization, as it would better align the traditional political and economic priorities of the different European regions. In this scenario, the periphery economic union would attempt to devalue its new currency in relation to the stronger core country currency, once again in an effort to make its exports more competitive on global markets.<sup>129</sup>

These presumed benefits seem to support a break-up of the Eurozone, but further reflection reveals that this third option would be detrimental to the members of the European Union and the global economy as a whole. The Eurozone is the compilation of over 60 years of political negotiations focused on preventing another European war. A collapse of the Eurozone would nullify the tremendous political gains that have been

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<sup>126</sup> Doluca, “European Redemption Pact: An Illustrative Guide,” 13.

<sup>127</sup> Ibid., 8–10, 13.

<sup>128</sup> Martin Wolf, “A Permanent Precedent,” *Financial Times*, May 17, 2012, <http://www.ft.com/intl/cms/s/0/614df5de-9ffe-11e1-94ba-00144feabdc0.html>.

<sup>129</sup> Lynn, *Bust*, 235–36.

made in the post-World War II era, the period after the conclusion of the Cold War, and the advancements in the age of globalization. These gains have ushered in an unmatched period of European peace and stability on a continent that has recently endured “barbarism” and “bloodlands.”<sup>130</sup> The disintegration of the Eurozone would promote nationalist ideals, create adverse political objectives, and stimulate potential military conflict within the region.<sup>131</sup>

A Eurozone break-up would also potentially induce catastrophic conditions in multiple European countries through the spread of economic contagion. If a periphery member state withdrew from the Union, foreign lenders would stop investing in other countries that they believe may also have to exit. As a result, a domino effect would ensue where other periphery countries would also not be able to meet their debt commitments and would have to exit the Union. This type of adverse effect has been experienced around the globe with notable incidents in South America, which started when Argentina defaulted on its debt payments, and in Asia, which began with a currency crisis in Thailand. In this scenario, a large sum of monetary assistance would be required to attempt to stop the spread of contagion. In the end, the forces acting against this effort may be too great to halt the economic and political turmoil that would follow.<sup>132</sup>

Finally, if a periphery member state exited the Eurozone, there would be no guarantee that rather than a recovery, the country may continue in a recession or experience a more damaging economic depression. The country would first incur a substantial expense in converting over to a new national currency. The nation may also witness a collapse in the value of its new currency within the global monetary markets, and the nation may induce dramatic inflation in rapidly introducing the new currency without a proven fiscal program.<sup>133</sup>

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<sup>130</sup> Bernard Wasserstein, *Barbarism & Civilization: A History of Europe In Our Time* (New York: Oxford University Press, 2007); Timothy Snyder, *Bloodlands: Europe Between Hitler and Stalin* (New York: Basic Books, 2010).

<sup>131</sup> Berend, *Europe in Crisis*, 136–38.

<sup>132</sup> Pugel, *International Economics*, 531.

<sup>133</sup> Berend, *Europe in Crisis*, 134.

A core country would likewise incur a tremendous cost in introducing a new sovereign currency, as well as inducing the economic and political damage that would result from leaving the Union. The nation would also create a substantial stress on the European Union organization as the intent is for all EU members to become Eurozone members. Further debate would have to ensue if this nation should stay in the EU or if it should also exit this organization. This would be similar to the current debate that is occurring within Britain, as this country does not want to convert to the euro currency and instead is discussing the potential for exiting the EU.<sup>134</sup>

A splintering of the Eurozone into two separate economic unions would introduce conflict within the EU and would dilute the economic power of the Eurozone on the global stage. Once again, the intent of the EU was for the European community to come together as one economic union. Two separate entities would introduce a conflict of interests into the Union and would create a north/south partition similar to a division observed in several countries throughout history that ultimately contributed to military conflict. A separation of the Eurozone would also dilute the coordinated economic power of the membership, and would produce a move that would contradict the global trend of increasing economic cooperation and unity. This desire for greater collaboration has been observed in the Asian markets as the Association of Southeast Asian Nations (ASEAN) is attempting to form an economic community and with the continued success of the North American Free Trade Agreement (NAFTA) trade initiative.<sup>135</sup>

## **B. GERMANY'S FATE?**

The question of whether the Federal Republic of Germany should stay in or exit the Eurozone has recently arisen with the continuing Eurozone sovereign debt crisis. In examining the two choices, consideration must be given to the political and economic

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<sup>134</sup> Ibid., 133–34.

<sup>135</sup> Lynn, *Bust*, 235–336; Stuart Grudgings, “Southeast Asia’s 2015 Unity Dream Collides with Reality,” Reuters, April 25, 2013, <http://www.reuters.com/article/2013/04/25/asean-unity-idUSL2N0DB08120130425>.

consequences of the decision. In addition to the reasons given above in discussing the three alternatives for the future of the Eurozone, specific reflection must be given to the German nation state.

Germany has become a beacon of prosperity within the European community in large part due to the Eurozone. The country has been able to substantially grow its export market due to the favorable exchange rates of the euro that must incorporate the weaker economies of the periphery states. This has, in effect, given German businesses a global trading advantage and has allowed the country to enjoy continuous trade surpluses. If the country reinstated the Deutsche Mark, the currency would presumably appreciate in relation to the euro and the legal tender would experience a new level of volatility not seen in the national currency since the early twentieth century. The strong financial conditions have also generated a high demand for the nation's debt securities, which has suppressed yields and interest rates, and at times, resulted in negative yields on German *Bunds*. If the country exited the Eurozone, its costs to service government debt would increase and the strength of the country's export market would dramatically decrease.<sup>136</sup>

Continuing with this scenario, if the country were to exit the Eurozone, the German Bundesbank would suffer large monetary losses that could potentially unhinge the iconic stability of the institution and with it Germany itself. As the country is the largest contributor to the EU financial assistance funds, the national bank is heavily leveraged in the recipient member states' ability to honor their repayment commitments. In addition, the Bundesbank has purchased large amounts of periphery government securities and member state bank debt in these rescue packages. If Germany leaves the Union, the country's national bank will be left with a large amount of devalued foreign assets in the ensuing Eurozone upheaval. This could lead to the adverse economic conditions that the bank has sworn to prevent, including the possibility of substantial domestic inflation and high unemployment.<sup>137</sup>

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<sup>136</sup> George Soros, "The Tragedy of the European Union and How to Resolve It," The New York Review of Books, September 27, 2012, <http://www.nybooks.com/articles/archives/2012/sep/27/tragedy-european-union-and-how-resolve-it/?pagination=false>; Lynn, *Bust*, 234–35.

<sup>137</sup> Lynn, *Bust*, 245.

The withdrawal of Germany from the Eurozone would leave a void in the Union that the organization may not be able to recover from. The country has become the foremost creditor and a leader in the Eurozone, acting in many regards in a similar role to that of the IMF, providing the funds needed to sustain the weaker periphery states. If this funding source was removed, one or more of the GIIPS members would most likely default on their debt, which would create the cascading effect of contagion. It is unlikely that France or another core country would have the monetary ability to subdue the negative trend towards a total collapse of the Union.<sup>138</sup>

A German exit from the Eurozone would also forfeit the strategic political position that the country now enjoys as a result of its economic contributions to the Union. As the nation state is the largest monetary contributor to the Eurozone, it also enjoys a large amount of political influence within the organization. This presents Germany with significant bargaining power to enact programs and reforms that coincide with the nation's principles and beliefs. In addition, the advantageous position within the EU allows the country to conduct its foreign policy agenda under the cover of the association. If Germany were to leave the Eurozone it would be forced to negotiate foreign and economic policy as a single nation rather than as a leader in a continent-wide union.<sup>139</sup>

Finally, a stout reason for Germany to remain in the Eurozone is the country's duty to prevent a repeat of the first half of the twentieth century. Germany is once again in a strong economic and industrialized position relative to its neighbors. The country has a growing economic advantage and a robust export-built manufacturing base that has the ability to support a domestic policy agenda that could adversely affect others outside its borders. Remaining in the Eurozone validates Germany's commitment to a unified Europe, builds mutual trust, and strengthens the inherent alliance that the country has

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<sup>138</sup> Converse, *Fiscal Crisis and World Order*, 110–11; Lynn, *Bust*, 235.

<sup>139</sup> Stephane Deo, Paul Donovan, and Larry Hatheway, "Euro Break-Up—The Consequences," UBS Investment Research, September 6, 2011, 16, <http://www.ubs.com/global/en/investment-bank/institutions/securities-research/economic-research.html>.

with its neighbors. As a result, Europe can focus on resolving the sovereign debt crisis and on improving the Eurozone's fiscal condition rather than diverting attention to military security and build-up.

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## VI. CONCLUSION

The Eurozone sovereign debt crisis has torn the fabric of Europe. The ongoing choices of policy made in response will determine if the danger is stabilized or if threat leads to an unrecoverable situation. The continuing recession within the periphery zone area has created Eurozone-wide volatile reactions and demonstrations that have generated an image that harkens back to the turmoil of the early twentieth century. The Eurozone governance, under the leadership of the German nation state, has the opportunity to use this crisis to enact the political reforms that are needed to create a viable and sustainable future.

The deteriorating unemployment situation within the Eurozone membership demonstrates the need for a swift and decisive response to what is rapidly becoming the leading threat to the Union. In April 2013, unemployment in the Eurozone rose to 12.2 percent, reaching a level not previously seen during the ongoing crisis. This total equates to 19.4 million unemployed Eurozone citizens and includes 3.6 million jobless under the age of 25. In addition, there are two million more unemployed youth in the other EU states. As history has shown, these levels of disenfranchised persons can quickly create radical and dangerous reform movements that lead to global conflict.<sup>140</sup>

This work has examined the timeline of agreements and treaties enacted within the European community that culminated with the implementation of the Eurozone monetary union. These evolving treaties demonstrate the steadfast political vision towards creating a unified and peaceful Europe, and one that culminates in an institution that ends the centuries of military conflict inherent within the region. Unfortunately, political action did not accompany this political vision as these treaties transformed into a monetary and economic union that did not have the sufficient political integration to ensure success. This has created a European crisis that is as much about politics as it is about economics.

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<sup>140</sup> Robin Emmott and Ingrid Melander, "Record Unemployment, Low Inflation Underline Europe's Pain," Reuters, May 31, 2013, <http://www.reuters.com/article/2013/05/31/eurozone-economy-idUSL5N0EC1CT20130531>.

The periphery member states' intrinsic beliefs, and subsequent actions taken in the first decade of the twenty-first century, culminated in the Eurozone sovereign debt crisis. Each country has a unique path that led to economic disaster, but all share the common trait of willfully choosing to spend more than they earned. The enticingly low-cost to borrow money permitted Greece, Italy, and Portugal to turn towards this source of income to provide funding to run their governments. Irish and Spanish residents took advantage of the inexpensive borrowing opportunities to focus on the real estate market. Citizens of these periphery countries also attempted to use these favorable economic conditions to catapult themselves to a higher level of living standards, which until now had been beyond their means. The collapse of the global financial markets that began in 2007 brought an abrupt end to this monetary bliss as credit dried-up and debts skyrocketed.

The ensuing economic crisis created the shocking possibility that a European country could go bankrupt in the twenty-first century. From May 2010 through March 2013, five sovereign rescue packages and one banking aid package totaling over half a trillion euros were needed to keep the Eurozone afloat. This financial assistance was only provided after the recipient nation agreed to strict austerity measures and internal structural reforms. Although these requirements created short-term benefits towards the recipient's balance sheet, in the long-term they have suppressed the economic recovery of the nation by forcing a decrease in domestic demand and creating barriers for growth. This has ultimately led to rising unemployment rates and the emergence of radical nationalistic movements and protests against the current political and economic conditions.

In the continuing effort to combat the Eurozone crisis, three organizations have emerged at the forefront of the recovery effort: the European Commission, the International Monetary Fund, and the European Central Bank, collectively referred to as the Troika. In the sovereign rescue packages provided to date, the Eurozone governance, under the leadership of the European Commission, provided financial aid jointly with the IMF. Since the beginning of the disaster, the European Central Bank's position in the economic crisis has evolved into taking a more proactive role. Under the leadership of

ECB President Mario Draghi, the bank has moved beyond its original mandate of fighting inflation to first enacting the limited and unconditional Securities Market Programme to finally unveiling the unlimited and conditional Outright Monetary Transactions package. In December 2011 and February 2012, the ECB also provided member state' banks with two aid packages, labeled long-term refinancing operations (LTROs), which provided 800 Eurozone banks with an unprecedented one trillion euros in low-cost, three year loans. The ECB will continue to play a vital role in the recovery of the Eurozone crisis.<sup>141</sup>

The European Central Bank's assistance would not have been as substantial without the Federal Republic of Germany's contributions. This nation state has arisen from the calamity of the early twentieth century to become a political and economic authority within the European Union. The country has developed into the second largest manufacturing exporter in the world and has become the largest contributor to Eurozone rescue funds and financial aid programs. As such, Germany has emerged as the leader of the Eurozone's core member states, which has allowed the nation to imbed its conservative economic values into the monetary union and subsequent rescue packages.

The 17 members of the Eurozone have three options for combatting the sovereign debt crisis: they may continue to "muddle through" the crisis, they may enact substantial reforms, or they may choose to splinter and break-up the Union. The leaders of the Eurozone have, so far, decided to take a largely reactive role, as they have only provided rescue funds as a member state was nearing bankruptcy. The austerity measures attached to these aid packages have repressed the chance for a region-wide recovery. The ECB aid programs have provided benefits to the Union, but are limited in their overall total potential without the full support of all Eurozone members, which includes most notably Germany.

The current conditions within the Eurozone have presented an opportune time to enact substantial reforms that will position the organization for a successful future. Expanding economic division between the core and periphery member states, rising

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<sup>141</sup> Barber, "FT Person of the Year: Mario Draghi."

unemployment, a persistent recession, and growing domestic discontent, all support the need to create a supranational political union that will supplant the existing economic organization. In addition, the issuance of Eurobonds will free the periphery member states from their debilitating debt levels and allow them to focus on economic recovery and growth.

As a result of the current crisis, one or more member states may be forced to exit the Eurozone, or the Union may experience a splintering into two factions. Each option would go against the original intent that was inherent within the treaties created soon after World War II; all of which had the goal to create a more unified and integrated Europe that would be positioned to promote peace and prevent future regional military conflicts. An exit of a current member state would also generate a tremendous economic cost to that nation, as well as potentially create a cycle of contagion that could destroy the Union. Finally, as an eternal motive against this option, Ivan Berend wisely observes: “Nothing proves European solidarity better than that every troubled member country was saved during the five years of crisis.”<sup>142</sup> Time will tell if this optimism holds true.

The current situation and future possibilities for the Eurozone are of considerable importance to the United States. The country has robust trade, investment, and financial ties with the European Community that would be adversely affected by a Eurozone economic catastrophe. The U.S. exports about \$400 billion in goods and services to Europe and has about one trillion dollars in foreign direct investments within the continent. U.S. financial institutions also lend about five trillion dollars to European entities. European nations also have large investments within the United States, as demonstrated by Germany’s \$212 billion foreign direct investments within the U.S. in 2008.<sup>143</sup> This has resulted in the largest and most highly integrated bilateral trade and

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<sup>142</sup> Berend, *Europe in Crisis*, 139.

<sup>143</sup> Raymond J. Ahearn and Paul Belkin, “The German Economy and U.S.-German Economic Relations,” Congressional Research Service, November 30, 2009, <http://fpc.state.gov/documents/organization/133909.pdf>.

investment relationship in the world. A continuing crisis will severely upset this economic partnership and will directly affect American stock indices and domestic jobs that are linked to European businesses.<sup>144</sup>

Just as the financial crisis that originated in the United States severely affected European institutions, a future disaster resulting from the continuing Eurozone sovereign debt crisis will quickly spread to the United States. This would derail the slow financial recovery that is occurring with the American economic sector and possibly catapult the country back to the harsh economic conditions that were encountered in 2007–2008. As such, the United States must continue its support of a Eurozone recovery through its 17 percent share of IMF funding and through the U.S. Federal Reserve’s program of providing U.S. dollar swap lines with the European Central Bank.<sup>145</sup>

In examining the choices presented to the Federal Republic of Germany, to either stay in or exit the Eurozone, the nation state will benefit more from remaining in the Union than it will from exiting the organization. In terms of the direct economic cost, a report prepared by UBS Limited estimates the cost of Germany leaving the Eurozone at between €6,000 and €8,000 per German citizen in the first year and between €3,500 and €4,500 in subsequent years. In contrast, the study estimates that it would only cost €1,000 per resident to bailout Greece, Ireland, and Portugal in their entirety. These figures demonstrate the tremendous monetary cost for the largest European economy to depart the Union.<sup>146</sup>

In addition to this outright financial cost, Germany would also suffer a tremendous political cost in exiting the Eurozone. Throughout the post-World War II period, the country charted an acquiescent course in an attempt to atone for the anguish caused by its previous regimes. Throughout the ensuing decades, the nation remained steadfast in its conservative economic policies and political beliefs. In time, as the Cold

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<sup>144</sup> *The Eurozone Crisis and Implications for the United States: Hearings on Eurozone Crisis, Before the Subcommittee on International Monetary Policy and Trade, 112th Cong.* 40–41 (2011), <http://www.gpo.gov/fdsys/pkg/CHRG-112hhrg72617/pdf/CHRG-112hhrg72617.pdf>.

<sup>145</sup> *Ibid.*, 52–55.

<sup>146</sup> Deo, “Euro Break-Up—The Consequences,” 1.

War ended, West Germany was faced with the new prospect of German reunification and the economic hardship of integrating an economically regressive East German state. This was followed by the period of European monetary unity that encouraged unwise economic practices throughout the newly formed Eurozone community. Even with these diversions, the country was able to transform itself to eventually become a leader, not only within the European community, but also on the global economic stage.

If Germany left the Eurozone it would forfeit the political and economic strides the country has attained in the nearly seventy years since the end of World War II. Germany's success has given the country the opportunity to transform from a secondary role into a leadership position with the European Union. This has allowed the country to promote its domestic doctrine, but more importantly has given Germany the opportunity to sponsor a lasting legacy of European peace and economic prosperity.

The distinguished *Transatlantic Trends* annual survey of 2012 presents a supporting atmosphere for German-led reforms. Polling data reveals that 73 percent of German citizens are still steadfast supporters of their country's EU membership, while 68 percent approve of the government's handling of economic policies. In addition, only 26 percent of Germans want to leave the Eurozone. In support of the substantial reforms that are proposed to resolve the Eurozone crisis, 53 percent of Germans are in favor of giving more power to the EU to manage national economic and fiscal policies. As the sovereign debt crisis lingers, this favorable polling data may decrease. As such, timely action should be taken in light of the current supportive German environment.<sup>147</sup>

Germany has the political influence and economic means to sponsor the needed transformation within the Eurozone. If the Union remains on its current path, repressive austerity measures and fiscal disadvantages will continue to hinder the periphery member states. As such, Germany and other core member states will be forced to continue to enact a piecemeal solution or risk a collapse of the Eurozone. The German nation state has the chance to promote the political reforms and to endorse the economic relief packages that are needed to move Europe forward. If the Federal Republic of Germany

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<sup>147</sup> "Transatlantic Trends 2012," German Marshall Fund of the United States, accessed February 25, 2013, 10, [http://trends.gmfus.org/files/2012/09/TT-2012\\_complete\\_web.pdf](http://trends.gmfus.org/files/2012/09/TT-2012_complete_web.pdf).

accepts this ambitious challenge, the country has the potential to reverse the nation's lasting impact on history, and in doing so, may transform the legacy of the German nation state from one remembered as creating the worst recent tragedy to one that enacted the greatest political reforms witnessed in the modern era.

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